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Internal Revenue Service

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Federal Estate and Gift Taxes

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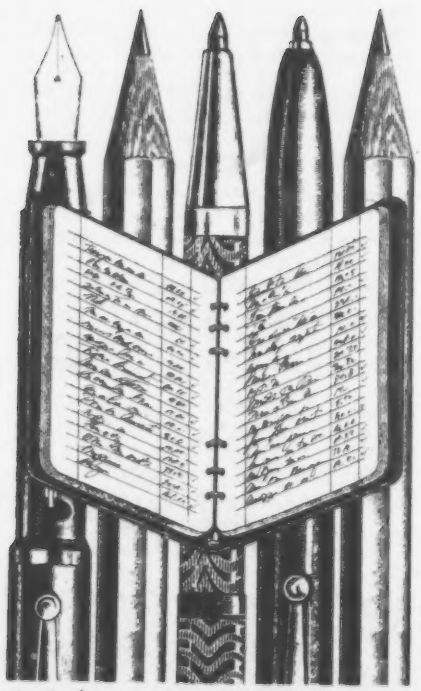

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Introduction

This publication is divided into four parts. Part I explains the application of the estate tax law and Part II explains the gift tax law. The changes made by the Tax Reform Act of 1976, the Revenue Act of 1978, and recent technical developments are incorporated in the discussions.

Part III discusses the tax on certain generation-skipping transfers that was added by the Tax Reform Act of 1976.

In Part IV, the procedures for requesting a factor, computation, or ruling from the Internal Revenue Service are discussed.

Public Law 96-167, signed by the President on December 29, 1979, made two changes that affect the gift tax filing requirements.

1) The time for filing gift tax returns for the fourth quarter of a calendar year is changed from February 15 to April 15.
2) Any extension of time granted for filing an income tax return is also deemed to be an extension of time for filing the fourth quarter gift tax return.

These provisions apply to returns for gifts that are made in calendar years ending after the date of enactment. See Part II for more information about the gift tax filing requirements.

The law also repealed section 6050 of the Code which required a transferor to file an information return (Form 4629) if income producing property valued at more than $50,000 is transferred to an exempt organization. This provision is effective for transfers of property made after December 29, 1979.

Part IV has been expanded to include revised procedures to be followed to promote efficient handling of requests for factors, computations, and rulings.

A new procedure has been added to provide guidance in properly utilizing the ***market data approach in appraising unimproved real property*** for federal income, estate, and gift tax purposes. See Section 8(A) of Part I.

For detailed questions outside the scope of this booklet, consult the Internal Revenue Code and Treasury Department Regulations.

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Part I
The Estate Tax

This Part explains the application of the federal estate tax law to the estates of individuals who die after 1976. The Tax Reform Act of 1976 and the Revenue Act of 1978 made numerous changes to the estate tax law; these changes generally became effective after 1976. The effective dates of recent law changes are shown.

The established time at the decedent's place of domicile at the instant of death determines the time and date of death of the decedent. It is the place of the decedent's domicile that decides where the estate tax return will be filed. It is there that the required actions in relation to the estate generally must be taken.

1.
Nature of the Estate Tax

Federal estate tax applies to the transfer of a decedent's property to beneficiaries. Unlike a state inheritance tax that is charged to each beneficiary of an estate and that is based on the size of the inheritance and the relationship of the beneficiary to the decedent, the federal estate tax applies to the entire estate. The estate is primarily liable for payment of the tax.

Generally, the relationship of the beneficiaries to the decedent and the amount of the various shares are not considered. (Certain exceptions are discussed later.) However, the beneficiaries of the estate may be called upon to pay the tax if the estate does not pay it when due. The beneficiaries' liability is limited to the value of the property they inherit. The value is determined at the time of the decedent's death.

2.
Estates Subject to Tax

A) Citizens or Residents of the United States

If an individual is a citizen or resident of the United States at the time of death, the value of his or her entire estate is subject to the estate tax. This rule applies regardless of where the individual's property is located. The term ***United States***, for this purpose, does not include U.S. possessions or territories.

B) Nonresidents, Not Citizens

For nonresidents, who are not citizens of the United States, only the value of their property that is located in the United States at the time of their death is subject to the estate tax. The tax on estates of nonresidents, not citizens, is discussed in detail in Section 12, *Estates of Nonresidents, Not Citizens*, of this Part.

C) Expatriates

For an individual who was a nonresident, not a citizen of the United States at death, because he or she had lost previous U.S. citizenship within 10 years of death, the estate tax is applied only to the property located in the United States and on certain foreign corporation stock. For more information concerning estate tax treatment of expatriates, see Section 12(F), *Expatriation to Avoid Tax*, in this Part.

3.
The Estate Tax Return

A) Citizens or Residents of the United States

Form 706, *United States Estate Tax Return*, must be filed if:

The individual dies in:	And the value of the gross estate exceeds:
1978	$134,000
1979	$147,000
1980	$161,000
1981 and thereafter	$175,000

Form 706 is due 9 months after the date of death of a U.S. citizen or resident.

The filing requirement amounts are reduced by the total amount of adjusted taxable gifts made after 1976 (other than those gifts included in the decedent's estate), and the total amount allowed as a specific exemption for gifts made after September 8, 1976, and before 1977.

If you, as the executor or administrator, are unable to make a complete return for any property interest in the gross estate, you must include on the return the name of everyone holding a legal or beneficial interest in that property and furnish a description of the property. If notified by the District Director, those holding legal or beneficial interest in this property should file a return for that part of the gross estate.

B) Nonresidents, Not Citizens

If a decedent was neither a resident nor a citizen of the United States, Form 706NA, *United States Estate Tax Return, Estate of nonresident not a citizen of the United States*, must be filed if the value of that part of the gross estate located in the United States exceeds $60,000. The filing requirement amount is reduced in the same manner as for a citizen of the United States. See the instructions for Form 706NA for more information about filing.

4.
Extension of Time to File the Return

A reasonable extension of time to file the estate tax return, or related statements or documents, may be granted if it is impossible or impractical to complete the return within the 9-month period after the date of the individual's death.

No extension may be granted for more than 6 months unless the person required to file the return is abroad.

Form to use. To request an extension of time to file, use Form 4768, *Application for Extension of Time to File U.S. Estate Tax Return and/or Pay Estate Tax*. File two copies of Form 4768 if you are requesting ***only*** an extension of time to file. If you are requesting an extension to file the return and to pay the tax, file four copies of Form 4768.

When to file. Form 4768 must be filed sufficiently early to permit the Internal Revenue Service to consider the application and reply before the estate tax due date.

Where to file. File the application with the Internal Revenue Service office where the estate tax return will be filed. File all applications relating to Form 706NA with the Internal Revenue Service Service Center, Philadelphia, PA 19255.

Information needed. Include a written statement with the application, showing sufficient cause why it is impossible or impractical for you as personal representative to file a reasonably complete return by the due date.

Paying the tax. If the application is for an extension of time only, you must include payment for the amount of the estate tax estimated.

Note. An extension of time to file does ***not*** extend the time to pay.

In case of failure to file an estate tax return when due (including any extensions of time for filing), a penalty of 5% per month, not to exceed 25%, will be added to the tax required to be shown on the return, unless reasonable cause is shown. The amount of any addition to tax for failure to file will be reduced by the amount of addition for failure to pay the tax shown on the return, explained later, for any month to which both of these additions apply.

5.
Extension of Time to Pay the Tax

Generally, you as an executor or administrator must pay the estate tax when the return is due without regard to any extension of time to file. You may request additional time to pay the estate tax for up to 12 months from the date the payment is due. The Internal Revenue Service will grant such a request whenever there is ***reasonable cause.***

Reasonable cause. The following examples illustrate reasonable cause.

1) An estate includes enough liquid assets to pay the estate tax when normally due. However, the liquid assets are located in several jurisdictions and are not within the immediate control of the personal representative. Thus, the personal representative cannot readily assemble the assets, even exercising due diligence.

2) Most of an estate's assets consist of rights to receive payments in the future. Examples of these assets include annuities, copyright royalties, contingent fees, and accounts receivable. These assets now provide insufficient cash to pay the estate tax due, and the estate cannot borrow against these assets without causing a loss to the estate.
3) An estate includes a claim to substantial assets that cannot be collected without a lawsuit. Thus, the amount of the gross estate cannot be determined when the tax is due.
4) An estate lacks enough funds (without borrowing at an interest rate higher than generally available) to:
   a) Pay the estate tax when due;
   b) Provide a reasonable allowance for the decedent's surviving spouse and dependent children while the estate is being administered; and
   c) Satisfy claims against the estate that are due and payable.

In addition, the personal representative has made a reasonable effort to convert the decedent's assets into cash (other than an interest in a closely held business as discussed later).

Form to use. To request an extension of time to pay the estate tax use Form 4768, *Application for Extension of Time to File U.S. Estate Tax Return and/or Pay Estate Tax.* File two copies of Form 4768 if you are requesting only an extension of time to pay the tax. If you are requesting an extension of time to file the return and to pay the tax, file four copies of Form 4768.

When to file. Form 4768 must be filed sufficiently early enough to permit the Internal Revenue Service to consider the application and reply before the due date.

Where to file. File the application with the Internal Revenue Service office where the estate tax return will be filed. File all applications relating to Form 706NA with the Internal Revenue Service Center, Philadelphia, PA 19255.

Information needed. Include a written statement explaining in detail why it is impossible or impractical to pay the full amount of the estate tax by the due date.

Payment of estate tax. Generally, the Internal Revenue Service will grant additional time to pay the amount of cash shortage. You should pay the amount of the estate tax in excess of the cash shortage with the application.

Note. An extension of time to pay does not extend the time to file. An extension of time to pay does not relieve the estate from liability for the payment of interest on the balance due during the period of extension.

In addition, the Internal Revenue Service may grant additional time for payment of the tax liability up to one year for any one period and for all periods not beyond 10 years from the due date of the original return. As executor, you must show reasonable cause in the application. For any installment payment, including any part of a deficiency payment, the extension may continue until 12 months after the due date for the last installment payment of the original estate tax liability.

If you have paid the tax and a deficiency still remains, the Internal Revenue Service may extend the time for paying the deficient amount for up to 4 years from the date otherwise fixed for payment when reasonable cause is shown.

In case of failure to pay the amount shown as tax on the return (without regard to any extension of time for filing), a penalty of one-half of 1% on the unpaid balance, not to exceed 25%, will be added if no reasonable cause is shown for the delay in payment. Failure to pay a tax deficiency that is later determined, within 10 days from the date of notice, will result in the addition of a similar penalty, unless reasonable cause is shown.

Reversionary or remainder interest. If the gross estate includes the value of a reversionary or remainder interest, you may elect to postpone the payment of the tax attributable to that interest until 6 months after the preceding interests in the property have ended.

If, at the end of this 6-month period, you show reasonable cause, the Internal Revenue Service may grant additional time up to 3 years for payment of the tax attributable to these interests.

A) Extension of Time for Payment of Estate Tax When Estate Consists Largely of Closely Held Businesses

As executor, if you include an interest in a closely held business in the gross estate, on or before the date otherwise fixed for the payment of the entire tax you may elect, under certain conditions, to pay the tax attributable to that interest in not more than 10 equal yearly installments. You must pay the first installment. You may make the election no later than the date fixed for the filing of the return (including extensions). If the Internal Revenue Service has granted an extension of time for filing, you will also be considered to have made a timely filed request for an extension of time to pay the first installment, if:

1) You pay the first installment of tax at the same time you file the estate tax return (within the extended filing period); and
2) You make the election to pay the tax in installments.

Interest in a closely held business means:

1) An interest as sole proprietor in a trade or business;
2) An interest as a partner in a partnership having not more than 10 partners, or in which the decedent owned 20% or more of the capital; or
3) Ownership of stock in a corporation having not more than 10 shareholders, or in which the decedent owned 20% or more of the voting stock.

The benefit of this provision of the law is available only to estates of decedents who were citizens or residents of the United States when they died.

This provision is available only if the value of the interest in the closely held business is more than 35% of the value of the gross estate or 50% of the taxable estate of the decedent.

If a decedent had an interest in two or more closely held businesses, the businesses may be treated as a single closely held business only if more than 50% of the total value of each separate business is included in the estate.

As executor, if you elect the reduced special use valuation for real property, you must also use that valuation to decide if the percentage tests are satisfied. The special use valuation is discussed in Section 8(G), *Special Farm or Other Closely Held Business Real Property Valuation,* of this Part.

A ***business*** can be a manufacturing, mercantile, or service enterprise as distinguished from management of investment assets. The ownership of royalty interests or the grouping of income-producing assets is not a business.

Alternate extension—5-year deferral, 10-year installment payment. As executor or administrator, you may elect a 15-year period in which to pay any estate taxes attributable to the decedent's interest in a farm or other closely held business. Make this election within the time, including extensions, to file the estate tax return. You may not do this if the election under the 35% and 50% tests is made.

To qualify, the value of the farm or closely held business must be more than 65% of the adjusted gross estate (the gross estate less expenses, indebtedness, and losses).

An interest in a closely held business is the decedent's interest immediately before death, as a proprietor in a trade or business carried on as a proprietorship, or as a partner, if:

1) At least 20% of the total capital interest in the partnership is included in determining the gross estate; or
2) The partnership had 15 partners or less.

This rule also applies if the decedent, at death, was a shareholder in a corporation with 15 shareholders or less, or if 20% or more of the value of a corporation's voting stock is included in determining the decedent's gross estate.

A stock or partnership interest that is community property, or held by husband and wife as joint tenants, as tenants by the entirety, or as tenants in common, is treated as owned by one shareholder or one partner for the numerical test for shareholders or partners.

Property owned directly or indirectly by or for a corporation, partnership, estate, or trust

is considered as owned proportionately by or for its shareholders, partners, or beneficiaries. However, with trusts, only beneficiaries with present interests are considered. By a present interest, it is meant that they have present rights to trust income.

The interest in a closely held farm business includes the interest in the residential buildings and other improvements occupied regularly by the owners, lessees, or employees running the farm.

For the 65% test, if the decedent had an interest in two or more closely held businesses, each business in which the decedent had more than a 20% interest may be combined, totaled, and treated as one business.

If you elect the special use valuation for qualified real property for estate tax purposes, you must also use the reduced value to decide whether the 65% test is satisfied.

Effect of alternate installment election. As executor or administrator, you may elect to defer the payment of principal, but not interest, for up to 5 years from the original due date for payment of the estate tax. The interest for the first 5 years is payable each year. According to the initial election, you may pay the principal in two to ten equal annual installments. However, after the first 5-year period, you must pay the interest, on the unpaid part in any period with each installment.

The most tax that you may pay in installments is an amount that has the same ratio to the estate tax liability as the value of the closely held business amount is to the amount of the adjusted gross estate.

Alternate installment election. Generally, if you make the election when you file the return, the election applies both to the tax originally due and to certain deficiencies. If you do not make the election when you file the return, you may pay the full amount of certain deficiencies (but not the original tax) in installments. As executor, you also may make a protective election under certain conditions. However, if you made this election on or before August 30, 1980, you will be permitted to revoke the election. See *Revocation of election* later in this discussion.

Time and manner of alternate installment election. As executor, you make the alternate installment election by attaching a notice to a timely filed estate tax return. The notice must contain the following information:

1) Decedent's name and taxpayer identification number as they appear on the estate tax return;
2) Amount of tax to be paid in installments;
3) Date chosen for payment of the first installment;
4) Number of annual installments, including the first installment, in which the tax is to be paid;
5) Properties shown on the estate tax return that make up the closely held business interest (identified by schedule and item number); and
6) The reasons for your conclusion that the estate qualifies for installment payments.

If you do not include information about the amount to be paid in installments, the date chosen for the payment of the first installment, or the number of installments, then the election is presumed to be for the maximum amount payable and is to be made in 10 equal installments. The first payment is due 5 years after the due date for payment of the estate tax.

Protective election. You may protectively elect to defer payment of any part of the tax that is still unpaid when the values are finally determined (or agreed to, following an examination of the return). This protective election also covers any deficiencies attributable to the closely held business interest. Extension of tax payments under this election depends on whether the final values meet the requirements for the alternate extension. However, a protective election does not extend the time for paying the tax. Such an extension must be granted under another provision of the Code.

You make a protective election by filing a notice of your election with a timely filed estate tax return. Within 60 days after the values are finally determined (or agreed to, as a result of an examination of a return), you must file a letter containing a final notice of election with the required information with the Service office where you filed the estate tax return. You must pay any previously unpaid tax and interest, now due, plus any unpaid tax and interest that is not attributable to a closely held business, when you file the notice of final election and that is not eligible for further extension (or currently extended) under another section of the Internal Revenue Code.

Other rules. If you elect to pay the estate tax under the 10-year installment extension, you may not elect the alternate extension. However, if you timely elect to either use the alternate extension or the 10-year installment extension, you may elect a protective extension for the other extension at the same time. If you then file a timely final election notice for the protective extension and pay any amount due currently following final determination of (or agreement as to) estate tax values, your original election for the other extension will be deemed to never have applied to the estate.

Example 1. On the basis of values shown on decedent John Blue's timely filed estate tax return, 60% of the value of John's adjusted gross estate consisted of a farm which was a closely held business. As executor, you made a protective election for the alternate extension when you filed John's estate tax return. You also applied for an extension of time to pay $15,000 of the $30,000 of estate tax due on the return. The requested extension was granted and was renewed at the end of one year.

Eighteen months after the return was filed and after examination of John's estate tax return, the value of the farm was found to be 67% of the adjusted gross estate. You agreed to the values as established on examination and to a deficiency of $5,000.

You then filed a final notice of election choosing a 5-year deferral followed by 10 annual installment payments and thereby terminated the previous extension because that amount of tax was then included under the alternate installment election. You could have extended payment of 67% of the total estate tax, or $23,450. $23,450 is eligible for installment payments and the election is considered to be for that amount. You are considered to have prepaid $3,450 of the tax since only $20,000 of the tax remained unpaid. The $3,450 is attributed to the first installment of $2,345 and to $1,105 of the second installment which would have been payable under the election.

Had you been granted an extension of time to pay the $20,000 of tax, $25,000 would remain unpaid when the final alternate installment election is made. Payment of the full $23,450 (67%) of tax which is attributable to the closely held business interest is included under the alternate election. The balance of unpaid tax ($1,550) is due upon expiration of the estate's previous extension.

You must pay all unpaid accrued interest with your final election notice. Since only 18 months have passed, no tax installments are due. Interest on the $5,000 deficiency is computed at 4% for the entire 18 months, and interest for 12 months of that period is currently due to be paid. Interest for the remaining 6 months is due at the next succeeding date for payment of interest. Interest on the $15,000 of tax extended under the general 10-year extension is figured at the rate determined under the general extension until the date of the final alternate extension election and is due upon termination of the extension. After that date, the interest on the $15,000 will also accrue at 4%.

Example 2. Jim Blue died in 1979. His estate owes federal estate taxes of $750,000, $500,000 of which is for a closely held business interest. Payment of the $500,000 was extended under the alternate extension rule. Jim's executor chose a 5-year deferral followed by ten annual installment payments. Only 63.16% of each installment is subject to the special 4% interest rate. The remainder is subject to the otherwise applicable interest rate. The same rule applies in figuring interest for the 5 years during which payment of tax is deferred. (This occurs because the 4% interest rate applies only to a maximum of $345,800 of tax less the $30,000 of unified credit allowable.)

Revocation of election. All estates which make the elections on or before August 30, 1980, may revoke their elections. To revoke an election, you must file a notice of revocation with the Internal Revenue Service Center where the original estate tax return was filed. This notice must be filed on or before January 31, 1981 (or if earlier, the date on which the period of limitations for assessment expires). The notice must contain the decedent's name, date of death, and taxpayer identification number. It must also contain the remittance of any additional amount of estate tax and interest determined to be due.

Appeal procedures. The District Director is responsible for determining if an ***election for the ten-year or the alternate installment method of payment*** meets the specific conditions explained earlier in this section. If it is determined that your election meets the requirements, no notice to that effect will be sent to you, as executor. You may assume that the election is acceptable, unless you are advised otherwise. Your election will be examined as soon as practicable after it is received.

If your election does not appear to meet the requirements, you will be given the opportunity for an Appeals conference, after filing a request for Appeals consideration, before a final decision is reached. The Chief, Appeals Office, will inform you of its decision.

You may also request that the matter be referred to the National Office for technical advice if you believe that a lack of uniformity exists as to the disposition of the issue, or that the issue is so unusual or complex as to warrant consideration by the National Office. You may make this request while the case is under the jurisdiction of either the District Director or Chief, Appeals Office.

6. Interest on Underpaid or Postponed Tax

As executor, you must pay interest on any amount of tax that is unpaid. The interest is due on or before the last date the payment of the tax is due, without regard to any extension of time for payment. The interest rate on these taxes is readjusted to the prime interest rate charged by banks during September of any year if 90% of the prime rate, rounded to the nearest full percent, differs by at least one full percentage point with the interest rate being charged by Internal Revenue Service. This readjusted rate will be fixed by October 15 of that year and goes into effect on February 1 of the next year. A readjustment may not be made earlier than 23 months after the date of any earlier adjustment.

A) Farms or Other Closely Held Businesses

Under the alternate extension—5-year deferral, 10-year installment payment election—for payment of estate tax (discussed earlier in Section 5, *Extension of Time to Pay the Tax*), the interest rate on the estate tax that is based on the first $1 million worth of farm or other closely held business property is 4%. The maximum amount of the estate tax that may be subject to the lower 4% interest rate is the lesser of:

1) $345,800 (the estate tax on $1 million) reduced by the amount of the allowable unified credit; or
2) The amount of the estate tax that is attributable to the farm or other closely held business and that is payable in installments as discussed earlier.

If you elect installment payments and the estate tax payable is more than the maximum amount to which the 4% interest rate applies, your installment payment will be treated as reducing the amount of the estate tax payable (to which the 4% interest rate applies). This reduction is in the same ratio that the 4% amount (item 1 or 2, described above) bears to the amount of the tax payable that has been extended for the farm or closely held business.

The regular rate of interest applies to the estate tax attributable to the value of such property that exceeds $1 million.

7. The Gross Estate

The gross estate includes the value of all property to the extent of the decedent's interest in the property at the time of death.

This section discusses the gross estate of a citizen or resident of the United States. The special rules that apply to estates of individuals who are neither citizens nor residents are discussed in Section 12, *Estates of Nonresidents, Not Citizens*, of this Part.

Qualified disclaimers by beneficiaries may have effect on federal estate, gift, and generation-skipping transfers. For a discussion of qualified disclaimers, see Section 10(B), *Qualified Disclaimers*, of Part II.

A) Property Owned by the Decedent

Property that was owned by a decedent at the time of death, and was transferred at death by a will or by intestacy laws, is included in the gross estate. Other property interests that the decedent did not own at death also may be included in the gross estate. They are discussed later. Property that the decedent owned at death that could not be transferred by the decedent's will or by the intestacy laws, such as a life estate created by another, is not included in the gross estate. However, the value of a remainder interest that can be ended by the act of a third party is included in the decedent's gross estate if it is not actually ended before the decedent's death. A claim for damages for pain and suffering is includible in a decedent's estate because it could have been recovered by the decedent before death. However, a wrongful death claim brought by the decedent's heirs is not included because it could not have been recovered by the decedent. Unenforceable death benefits paid to the decedent's surviving spouse are not included in the estate.

Outstanding dividends declared to stockholders of record before, or on, the date of the decedent's death are included in the gross estate. Those declared after the date of death are not.

Unpaid interest that has accrued on savings certificates (redeemable after death without forfeiture of interest) from the date of the last interest payment to the date of death, plus the face amount of the certificates, is includible in the gross estate.

If the decedent's estate is entitled to a refund because of an overpayment of income tax liability, the overpayment is an asset includible in the gross estate. If the decedent's estate and a surviving spouse are entitled to a refund because of overpayment of a joint income tax liability, a portion of the overpayment is includible in the gross estate. The includible amount is the amount by which the decedent's contributions toward payment of the joint income tax exceeds the decedent's income tax liability. The decedent's income tax liability for the period covered by the joint return is figured as follows:

1) Figure the amount of income tax for which the decedent would have been liable on a separate return (as if a separate return had been filed).
2) Figure the amount of income tax for which the decedent's spouse would have been liable on a separate return.
3) Multiply the joint tax liability by a fraction. The numerator of the fraction is the amount figured in (1). The denominator of the fraction is the total of the amounts figured in (1) and (2).

The amount arrived at in (3) is the decedent's income tax liability for the period covered by the joint return.

Medical insurance reimbursements are included in the gross estate if the amount was due an individual at death.

List real estate that the decedent owned at death on Schedule A, Form 706. List stocks and bonds on Schedule B and include the stock CUSIP number, if available, for each of the securities. Enter bank accounts, promissory notes or other evidence of debt on Schedule C. List miscellaneous property, such as furniture, jewelry, personal effects, and the decedent's interests in partnerships or unincorporated businesses, on Schedule F.

B) Dower and Curtesy Interests

The value of a surviving spouse's dower or curtesy interest in the decedent's estate, including a statutory interest in place of the dower or curtesy interest, is includible in the decedent's gross estate.

A dower interest is the part of a deceased husband's real property allowed to his widow for her lifetime. A curtesy interest is the real estate property owned by a wife, at death, that passes to her husband for his lifetime if they have had children who were able to inherit the property.

C) Transfers with Retained Life Estate

The gross estate includes the value of property transferred after March 3, 1931, but before death, if the decedent kept possession or enjoyment of, or reserved certain rights or interests in the property, including the right to income in the property for life (or for a period

that does not in fact end before the decedent's death, or that cannot be determined without reference to the decedent's death). However, if the transfer of property was made for its full worth in money (or other equal value), it is not included in the gross estate. The rights or interests that may be reserved for life include the use, possession, income, or other enjoyment of the transferred property, or the right to name persons who may possess or enjoy the transferred property or its income.

The right to designate may be exercisable alone, or, if created after June 6, 1932, with others. It does not matter if the others have adverse interests, or if they or the decedent act in a special position, such as a trustee or agent.

If the decedent kept or reserved one or more of these rights or interests, the amount includible in the gross estate is the value of the property transferred, less the value of any outstanding income interest not subject to the decedent's interest or right. For its value to be excluded from the gross estate, the income interest must actually be enjoyed by another person at the decedent's death. If the decedent kept or reserved an interest or right to only a part of the transferred property, the amount includible in the decedent's gross estate is a comparable part of the entire value of the property.

The use, possession, right to the income, or other enjoyment of the property is considered kept by or reserved to the decedent to the extent that such use, etc., is to be applied toward the discharge of a legal obligation of the decedent or otherwise for the decedent's profit. The term ***legal obligation*** includes a legal obligation to support a dependent prior to the decedent's death.

The retained life estate need not be legally enforceable, as long as a substantial economic benefit is in fact reserved. If a father transfers the title to his residence to his daughter, but at the same time privately reaches an understanding that he is to continue living there until his death, the value of the residence is included in the father's estate even though the understanding could not be legally enforced. However, if a husband transfers the title to his residence to his wife and they both continue to occupy it, no presumption of a retained life estate is present unless an agreement exists.

A reservation by the decedent ***for any period not ascertainable without reference to his or her death*** is shown in the following examples:

Example 1. A decedent reserved the right to receive the income from transferred property in quarterly payments with the condition that no part of the income between the last quarterly payment and the date of death was to be received by the decedent or the decedent's estate.

Example 2. A decedent reserved the right to receive income from transferred property after the death of another person who, in fact, survived the decedent and was enjoying the income from the property at the time of the decedent's death. In this case, the amount to be included in the decedent's gross estate as a transfer with a retained life estate is the value of the entire property, less the value of the outstanding income interest of the other person. If the other person died before the decedent, the reservation by the decedent may be considered to be either for the decedent's life, or for a period that does not in fact end before the decedent's death.

The gross estate includes the value of property placed in trust by the decedent if the income beneficiary of the trust in turn created a comparable trust naming the decedent the income beneficiary. The trusts must have been interrelated, and the parties must have been in substantially the same position after the creation of the trusts as they would have been had they named themselves income beneficiaries of their own trusts.

Transfers to testamentary trust by a life income beneficiary. If a life income beneficiary has made lifetime contributions of property to a trust established by another person and the property remains in the trust at death, the retained interest to be included in the estate of the beneficiary is the value of the property at the time of death.

Example. Robert Blue was the life income beneficiary of a trust created by his father's will in 1974. The terms of the trust provided that the trustee had the power to receive and invest additions to the corpus and that the trust ended upon Robert's death with all assets passing to Robert's heirs.

When created, the value of the trust corpus was $10,000, and by December 21, 1976, the trust assets were worth $15,000. On that day, Robert transferred 400 shares of Maple Corporation common stock valued at $45,000.

Robert died on May 1, 1979, when the total trust assets were worth $400,000. The total value of trust assets included the 400 shares of Maple Corporation stock with a value of $350,000.

Since the value of the 400 shares of Maple Corporation stock could be determined on the date of Robert's death, his gross estate includes, as a retained interest, $350,000, the part of the trust equal to the value of the Maple Corporation stock on the date of his death.

If the trustee sold or otherwise disposed of the property contributed, and replaced it, the value of the interest the decedent had retained is that part of the trust assets the decedent contributed, figured at the time of the transfer.

Voting rights in controlled corporation stock. If a decedent transferred stock of a ***controlled corporation*** after June 22, 1976, and kept the right to vote in the shares (either directly or indirectly), the retention of the voting rights is a retention of the enjoyment of transferred property. The value of the transferred stock is included in the gross estate.

Controlled corporation. A corporation is a controlled corporation if at any time after the transfer of property and during the 3-year period ending on the date of the decedent's death, the decedent—

1) Directly or indirectly owned, or
2) Had the right, either alone or together with any person, to vote,

stock having at least 20% of the total combined voting power of all classes of stock.

In determining whether the corporation is a controlled corporation, the decedent is considered to own stock under the following rules.

1) ***Members of the family.*** A decedent is considered as having owned the stock held directly or indirectly by (or for):
   a) A spouse (other than a spouse who is legally separated from the decedent under a decree of divorce or separate maintenance); or
   b) A child, grandchild, or parent. A legally adopted child is treated the same as a natural one.
2) ***Partnerships and estates.*** Stock owned, directly or indirectly, by or for a partnership or estate is considered as having been owned by its partners or beneficiaries in proportion to their interest in the partnership or the estate;
3) ***Trusts.*** Stock owned, directly or indirectly, by or for a trust is considered as having been owned by the beneficiaries in proportion to their actuarial interest. (Stock owned by a tax-exempt qualified employee benefit plan trust is not included.) Stock owned, directly or indirectly, by or for any part of a trust of which a person was considered the owner or substantial owner is considered as having been owned by that person;
4) ***Corporations.*** If 50% or more in value of corporation stock was owned, directly or indirectly, by or for any person, that person is considered as having been the owner of any stock held (either directly or indirectly) by or for the corporation in the proportion that the value of the stock that person owned bears to the value of all the stock in the corporation; and
5) ***Options.*** If the decedent had an option to acquire stock, the stock is considered as having been owned by the decedent. An option to acquire that option and each one of a series of those options is considered an option to acquire the stock.

These transfers are included in Schedule G, Form 706.

D) Transfers Taking Effect at Death

The gross estate includes the value of property interests transferred by the decedent after September 7, 1916, except to the extent that the transfer was made for its full worth in money (or other equal value), if all of the following conditions exist:

1) Possession or enjoyment of the property transferred could have been obtained by the beneficiaries, through ownership of the property, only by surviving the decedent;
2) A reversionary interest in the property was kept by the decedent; and
3) The value of the reversionary interest immediately before the decedent's death was more than 5% of the value of the entire property.

First condition. The first condition is met if the only way any beneficiary can get possession or enjoyment of the property through ownership of it is by surviving the decedent.

Example 1. The decedent-husband transferred property in trust with the income payable to his wife for life. At her death, the remainder interest passes to the decedent's then surviving child, or if there is no surviving child, to the decedent or his estate. Since each beneficiary can possess or enjoy the property without surviving the decedent, no part of the property is includible in the decedent's gross estate as a transfer taking effect at death, regardless of the value of the decedent's reversionary interest.

Example 2. The first condition would be met if the decedent-husband transferred property in trust with the income payable to his wife for her life with the remainder payable to the decedent or, if he is not living at his wife's death, to their child or their child's estate. The child cannot obtain possession or enjoyment of the property without surviving the decedent. Therefore, if the decedent's reversionary interest immediately before his death was more than 5% of the value of the property, the value of the property, less the value of the wife's outstanding life estate, is includible in the decedent's gross estate.

Second condition. The second condition is met if the decedent kept a reversionary interest in the property transferred. ***Reversionary interest*** includes a possibility that the property transferred by the decedent may return to the decedent or to the decedent's estate and a possibility that the property may become subject to a power of disposition by the decedent. The term generally refers to any right under which the transferred property will or may be returned to the grantor. It does not matter if the right arises by the express terms of the instrument of transfer or by operation of law. However, if the transfer was made before October 8, 1949, and if the right to the return of the property does not arise because of the express terms of the instrument of transfer, the value of the property transferred is not includible in the gross estate as a transfer taking effect at death, regardless of the value of the reversionary interest.

The possibility of receiving income only from the transferred property after the death of another person is not a reversionary interest within the meaning of that term. The term ***reversionary interest*** does not include the possiblity that the decedent during lifetime might have gotten back an interest in the transferred property by inheritance through the estate of another person.

Example. Kevin Spruce transferred property in trust with the income payable to his wife for life and the remainder payable to himself or, if he was not living at his wife's death, to their child or the child's estate. By the terms of the trust, Kevin kept a reversionary interest because he kept the right to have the property returned to him if he survived his wife. He had this right up to the moment preceding death.

Third condition. The third condition for includibility is met if the value of the reversionary interest, as of the moment preceding death, is more than 5% of the value of the property transferred. See Section 8(E), *Annuities, Life Estates, Terms for Years, Remainders, and Reversions*, of this Part, for the method of determining the value of a reversionary interest.

Death benefit under employment contract. An employment contract may provide that the employer will pay a death benefit during the term of the contract to the employee's spouse or to the employee's estate if the spouse dies before the individual. This is a transfer that takes effect at death. The employee retained a reversionary interest in the death benefit. If the value of the reversionary interest in the death benefit at the moment before death exceeded 5% of the payment, the value of the death benefit is included in the employee-decedent's gross estate.

Example. John Elm entered into an employment contract with Maple Corporation. The employment contract provides that, in consideration of John's services, Maple Corporation will pay a stated death benefit to John's wife, if John is an employee of the corporation at his death. If John's wife dies before him, the contract allows the benefit to be paid to his estate.

After John's death, the death benefit was paid to his wife under the terms of the contract. The value of John's reversionary interest in the death benefit payment was more than 5% of the value of the payment at the moment before death.

Because the interest meets all three conditions described in this section, the value of the death benefit is includible in John's estate.

These kinds of transfers are listed on Schedule G, Form 706.

E) Revocable Transfers

The gross estate includes the value of property interests transferred by a decedent that were subject to an exercisable power of the decedent, as described later (except to the extent that the transfer was made for its full worth in money, or other equal value). If the enjoyment of the property transferred was subject to any power of the decedent to change or end the transfer on the date of death, the value of that property interest is included in the gross estate. The same result occurs if the power was given up by the decedent within the 3-year period ending on the date of death. A decedent's power to change the beneficiaries or to hasten or increase any beneficiary's enjoyment of the property are examples of this. The decedent, either alone or with others, must have held this power at the time of death or within the 3-year period ending on the date of death. However, if the use of the power was limited by a condition beyond the decedent's control, and that condition did not occur before death, the property is not included in the gross estate as a revocable transfer.

The capacity in which a decedent could use the power has no bearing. If the decedent gave property in trust, and was the trustee with the power to revoke the trust, the property would be included in the gross estate of the decedent. If the decedent named another person trustee but kept the power to later appoint himself (or herself) trustee with power to revoke, the property also would be included in the gross estate. (A similar result occurs if the decedent reserved the power to remove the trustee at will and appoint another trustee.) If, however, the power to change or end was held at all times solely by a person other than the decedent and the decedent reserved ***no*** right to assume these powers, the decedent's gross estate does not include the value of this property.

Property interests generally are included in the decedent's gross estate even though the power to change or end them could be used by the decedent only along with others, regardless of their capacity or interests. There are ***two exceptions.***

First, transfers made before 1924 are not includible if the power can be used only in conjunction with a holder of a substantial adverse interest.

Second, property is not included in the decedent's estate regardless of when it was transferred, if the decedent's power could be used only with the unanimous consent of all parties having an interest in the property, and if the power added nothing to the rights of the parties under local law.

The power may arise from the express provision of the transfer, by operation of law, or by an unrelated action at a later date. It is not necessary that the decedent kept the power on the date of the transfer (except for transfers occurring before June 23, 1936) as long as the decedent had the power at the date of death or within the 3-year period ending at death.

Only the part of the transferred property that is subject to the decedent's power, as described in the preceding paragraphs, is included in the gross estate.

Revocable transfers are listed on Schedule G, Form 706.

F) Annuities

The gross estate includes the value of an annuity or other payment receivable by any

beneficiary, by reason of surviving the decedent, under certain plans, contracts, or agreements entered into after March 3, 1931, (other than life insurance) to the extent that the value of the annuity or other payment is based on contributions made by the decedent or the decedent's employer.

A pure annuity contract that provides periodic payments to a person for life and ceases at the person's death, is not included in the person's gross estate. Only certain annuities that continue to provide payments to surviving beneficiaries after the decedent dies are included in the gross estate. The inclusion of the proceeds of a life insurance contract on the decedent's life is determined under special rules discussed later in *I) Proceeds of Life Insurance.*

Either of two conditions is required to include the annuity or other payment receivable by the beneficiary. They are—

1) The annuity or other payment must be payable to the decedent, either alone or in conjunction with another person or persons,
   a) For the decedent's life, or
   b) For any period not ascertainable without reference to the decedent's death, or
   c) For any period that does not in fact end before the decedent's death; or
2) The decedent must have possessed, for any period described in (1) the right to receive such an annuity or other payment, either alone or in conjunction with another person or persons.

Any period not ascertainable without reference to the death of the decedent is explained earlier in *C) Transfers with Retained Life Estate.*

The term ***annuity or other payment*** as applied to both the decedent and the beneficiary refers to one or more payments extending over any period of time. The fact that the payments are not made in equal amounts or at regular intervals is immaterial. ***Contracts or agreements*** include any arrangement, understanding, or plan that is due to the decedent's employment.

An annuity or other payment was payable to a decedent if, at the time of death, the decedent was in fact receiving an annuity or other payment, with or without an enforceable right to have the payments continued. The decedent had the right to receive an annuity or other payment if, immediately before death, the decedent had an enforceable right to receive payments at some time in the future, whether or not, at the time of death, the decedent had a present right to receive payments.

The fact that an annuity or other payment is not includible in the decedent's gross estate under the provisions discussed in this section does not necessarily prevent its inclusion under some other applicable provision of law.

If the decedent contributed only part of the purchase price of the contract or agreement, the gross estate includes, under the provisions discussed in this section, only that part of the value, at the decedent's death, of the annuity or other payment receivable by the surviving beneficiary that is proportionate to the decedent's contribution compared to the total purchase price. Contributions made by the decedent's employer (or former employer) to the purchase price of the contract or agreement are considered made by the decedent if made because of the decedent's employment unless the payments are made under a qualified plan.

Exemption of certain annuities. All or a part of the value of an annuity or other such payment receivable by any beneficiary, other than the executor, may be excludable from the decedent's gross estate if the payment is made under:

1) A trust forming part of a ***qualified*** employees' pension, stock bonus, or profit-sharing plan;
2) An annuity contract purchased by an employer under a ***qualified*** annuity plan;
3) An annuity contract purchased for an employee by certain tax-exempt organizations or public schools;
4) The Retired Serviceman's Family Protection Plan or Survivor Benefit Plan; or
5) An individual retirement arrangement.

However, lump-sum distributions under ***qualified*** plans are not excludable unless the recipient of the distribution irrevocably elects not to treat any part of the distribution as taxable under the 10-year averaging method or as long-term capital gain.

No exclusion is allowable to the extent that the amounts payable after death are based on payments or contributions made by the decedent. The gross estate includes only that part of the value of the amount payable that is proportionate to the total payments made by the decedent compared to the total payments made.

If the annuity is receivable by a beneficiary other than the decedent's personal representative and ***if the decedent made no contributions to its cost under the plan***, no part of the annuity's value is includible in the gross estate. In order for these provisions to apply, however, the decedent must be the employee who accrued the benefits under the plan rather than merely a beneficiary who was entitled to benefits.

Qualified pension, stock bonus, or profit-sharing plan, or qualified annuity. Generally, contributions or payments made by the decedent's employer, or former employer, under a trust or plan forming part of a qualified pension, stock bonus or profit-sharing plan, or under a qualified annuity plan are not considered made by the decedent to the extent such contributions or payments are excludable from gross income.

Constructive receipt. No exclusion from the gross estate is allowable if the employee's interest in a qualified ***noncontributory profit-sharing plan*** has been made available to the employee without any significant penalty or restriction on the exercise of his or her right to obtain full possession of the interest. If such a right of withdrawal existed before the employee's death, the value of the annuity or other payment to the surviving beneficiary is includible in the gross estate.

An annuity that is not included in the gross estate, as an annuity, may still be subject to inclusion under another rule. For example, survivor annuity payments that remain payable at a survivor's death, under a qualified noncontributory plan, are includible in the survivor's gross estate if the survivor had the unrestricted power to select the beneficiary of the remaining payments. See *Powers of Appointment,* discussed later.

Self-employed individuals. Generally, contributions to a qualified plan as described in (1) or (2) made by, or for, the decedent, while self-employed, are considered employer contributions to the extent such contributions or payments are deductible from gross income. In other words, amounts payable to the beneficiary (other than the executor) under a self-employed retirement plan are usually excluded from the gross estate of the decedent.

Annuity contract purchased by certain tax-exempt organizations. A tax-exempt employer's contributions for the purchase of an annuity, which are more than the amounts excludable from the employee's gross income, are considered to be contributions made by the decedent.

Retired Serviceman's Family Protection Plan or Survivor Benefit Plan. The gross estates of armed service personnel, or former armed service personnel, do not include the value of annuities for a surviving spouse, or for beneficiaries who are children, paid under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan. However, this exclusion does not apply to the extent the value of the annuity for the survivor is based on amounts deposited by the decedent into the retirement plan during any period after retirement, or for any period the decedent had become entitled to retirement or retainer pay. These deposits should not be confused with a member's election to receive a reduced annuity in order to provide survivor benefits. The deposits are out-of-pocket expenditures made by the retiree during a period when the retiree was not receiving annuity payments.

Death benefits payable under the Public Safety Officers' Benefit Act, which provides for the payment of benefits to survivors of local, state, and federal public safety officers who died in the performance of duty, are not includible in the gross estates of such decedents.

Amount included in gross estate. For these qualified plans, the gross estate includes a share of the value at the decedent's death of the annuity or other payment receivable by the beneficiary. To figure the includible amount, multiply this value by the employee's contribution and divide this by the

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total contributions on the employee's account to the plan, or towards the purchase of the annuity contract.

In certain cases, the employer's contribution to a plan on the employee's account, and thus, the total contributions to the plan on the employee's account, cannot be readily determined. To figure the amount to be included in these cases, the method that follows must be used unless a more precise method is presented. In these cases, the total contributions to the plan on the employee's account is the value of any annuity or other payment payable to the decedent and the decedent's survivor figured as of the time the decedent's rights first mature (or as of the time the survivor's rights first mature if the decedent's rights never mature).

Example. Under a qualified pension plan, the employer and the employee contributed to a trust which was to provide the employee, on his retirement at age 60, with an annuity for life. The plan also was to provide the spouse of the employee, upon the employee's death after retirement, with a similar annuity for life. The employer's contributions to the fund were not credited to the accounts of individual employees by the employer.

The amount included in the estate of the decedent was $4,000 determined as follows:

1) Value of the employee's annuity and the annuity of the spouse computed at the time of retirement	$40,000
2) Employee's contribution to the plan (including accrued interest)	$10,000
3) Value at the decedent's death of the spouse's annuity	$16,000
4) Amount includible:	
$\frac{\$10,000}{\$40,000} \times \$16,000 =$	$ 4,000

Employee contributions previously refunded at retirement. If an individual contributes to a qualified pension plan with separately maintained and segregated accounts for employer and employee contributions and elects, at retirement, to receive a lump-sum refund of employee contributions with accrued interest, any survivor annuity payable to the spouse of that individual is solely attributable to employer contributions. Thus, the survivor annuity is excludable from the gross estate.

Example. Paul Black was employed by State X until his retirement in 1975. Before retirement Paul was a participant in the State X employee pension plan, which was a qualified plan.

Under the plan, State X contributed a stated percentage of the total compensation paid to participants to the plan. A participant could contribute a percentage of annual compensation to the plan. The contributions of a participant and State X are deposited in the same trust fund; however, the contributions made by a participant and the additions to it are always segregated, separately maintained, and precisely determinable. The contributions made by State X also are maintained in a separate account.

Under the plan, a retiring employee may elect to receive retirement benefits under one of several options. One option permits an employee to receive a refund of all employee contributions (with accrued interest) along with a pension to the retiree and an annuity to the employee's surviving spouse. Since the amount payable under this option is based only on employer contributions, the amounts of pension and survivor annuity payable are less than under other options.

At Paul's retirement, he elected to receive benefits under the above option. He received a lump sum consisting of his contributions (with interest) and a pension during his life. Paul died in 1979, and his wife was eligible to receive an annuity for her life.

The survivor annuity payable to Paul's wife is excludable from Paul's gross estate since the survivor annuity is based solely on the separately maintained and segregated contributions of the employer.

Annuity interests created by community property laws. Only one-half of the value of the survivor benefits are includible in the decedent's gross estate when the decedent made the contributions to a qualified plan from community funds.

In most community property states, a taxpayer's spouse is considered to have an interest in the earnings and accumulated benefits of the taxpayer.

If contributions are made to a qualified trust by an employer (or former employer) or if payments are made to buy a qualified annuity for an employee that are not considered as contributed by the employee, and the employee's spouse dies before the employee, the deceased spouse's community interest in the employee spouse's accumulated benefit is excluded from the gross estate to the extent that:

1) The interest of the deceased spouse was based on employer contributions or payments; and
2) The interest arose solely as an interest in community income under a state's community property laws.

The value of the deceased spouse's community property interests ***attributable to contributions made by the employee spouse*** are includible in the deceased spouse's gross estate.

Civil service retirement benefits. For estate tax purposes, state community property laws do not apply to annuities, death benefits, or refunds payable under the Civil Service Retirement Act. Therefore, the value of the retirement benefits includible in the gross estate is not reduced by reason of the community property laws.

If the spouse of a retired civil service employee dies before the civil service employee, the deceased spouse has no community interest in the surviving spouse's civil service retirement benefit. Therefore, no part of the civil service retirement benefits is includible in the gross estate of the spouse who predeceases the spouse who was the civil service employee.

Individual retirement arrangements. The value of an annuity receivable by a beneficiary (other than an executor) under an individual retirement arrangement is excluded from the decedent's gross estate. The annuity must provide for a series of substantially equal periodic payments to be made to the beneficiary for life or over a period ending at least 36 months after the decedent's death.

The exclusion is limited only when any payment, such as an excess contribution, to, or for, the account was not allowable as a deduction for income tax purposes. The exclusion, however, generally applies to a rollover from a qualified plan, an annuity contract, or another individual retirement arrangement even though no tax deduction was allowable for the rollover contribution. However, the exclusion does not apply to a rollover from a qualified plan or an annuity contract that is made by the surviving spouse of a deceased employee.

Under the limitation, the part of the value of the amount receivable from the account, which is included in the gross estate, is based on the ratio between the total amount that was not allowable as an income tax deduction or was a rollover by a surviving spouse and the total amount paid to or for the individual retirement arrangement.

The exclusion also is available if the contributions were deductible for income tax purposes under a spouse-covered individual retirement arrangement.

Annuity interests are listed on Schedule I, Form 706.

G) Joint Interests

The gross estate includes the value of property held jointly at the time of the decedent's death by the decedent and another person or persons with the right of survivorship. However, that part of the property that was acquired by a joint owner, or owners, for adequate and full consideration in money or money's worth, or by bequest or gift from a third party is not included in the gross estate of the other joint owner. The decedent's estate must prove that the other joint owner, or owners, acquired their interests for consideration, or by bequest or gift. Consideration given by the surviving joint owner, or owners, does not include money or property that was acquired from the decedent for less than a full and adequate consideration in money or money's worth. This general rule applies to all joint interests created before 1977 unless an election is made to treat pre-1977 joint interests as ***qualified joint interests***, discussed later. It also applies to joint interests created after 1976 unless the interests are ***qualified joint interests.***

A special rule is provided, for the estates of individuals who died after 1978, for excluding part of the value of jointly owned property

used in a farm or other business. This rule is discussed later in this section.

If property held in joint tenancy by spouses is purchased with community property funds in which the spouses had vested equal interests, each spouse is considered to have contributed half of the consideration for the jointly held property. Only one-half of the value of such property is included in the gross estate of the decedent-spouse.

If the owners of property in joint tenancy were jointly and severally liable on a mortgage on that property, and, if, at the death of a joint tenant, the mortgage is outstanding, the surviving joint tenant's total contribution to the purchase is the sum of that survivor's actual payments for the purchase, later mortgage payments, and one-half of the mortgage indebtedness that remained outstanding at death.

Uniform Simultaneous Death Act. Certain states have adopted the Uniform Simultaneous Death Act to provide for the devolution of property when persons have died simultaneously.

The Act provides that when property is held jointly by the decedents the property is to be distributed one-half as if one had survived the other and one-half as if the other had survived.

Following the Uniform Simultaneous Death Act, one-half of the value of the property is includible in the gross estate of each of the joint tenants.

When one joint tenant has contributed the entire consideration for the property held jointly, the full value of the property is included in that one joint tenant's estate.

If the joint tenants are spouses (tenants by the entirety) the marital deduction is available for the one-half of the property that is included in each spouse's estate. See *9(D) Marital Deduction*, for more information about determining that deduction.

Qualified joint interests. One-half of the value of a qualified joint interest at the date of death or on the alternate valuation date is included in the gross estate of a decedent, no matter how much each spouse provided toward the purchase price.

A qualified joint interest is any interest created after 1976 held by the decedent and the decedent's spouse as joint tenants or tenants by the entirety, but only if the interest was:

1) Created by the decedent, the decedent's spouse, or both; and
2) A completed gift, if the interest is in personal property; or
3) Treated as a taxable gift when the joint interest was created, if the interest is in real property.

In a joint tenancy only the decedent and the decedent's spouse may be joint tenants.

Because the joint interest must be created by one or both spouses, a joint tenancy inherited by both spouses is not a ***qualified joint interest*** since it is not created by one or both of the spouses.

For personal property, the gift must be a completed gift. Therefore, a joint bank account does not qualify if the donor keeps the right to withdraw all funds.

Election to have a pre-1977 joint tenancy treated as a qualified joint interest. Before 1980, a donor could elect to treat a joint interest in property created before 1977 as a ***qualified joint interest*** without going through the formal steps of severing the joint interest and re-creating a qualified joint interest. After 1979, a donor must go through the formal steps of severing and re-creating a joint interest in order to obtain treatment as a qualified joint interest. The pre-1977 joint interest must have met the requirements discussed earlier for a qualified joint interest that is created after 1976, with one exception; that exception is that requirement (3) does not have to be met.

A substantial improvement of any property is treated as the creation of a separate joint interest for joint interests created before 1977 that are electing to be treated as a qualified joint interest.

Treatment of post-1976 terminations. If a pre-1977 joint tenancy was severed and re-created after 1976, the donor may elect to have the re-created joint tenancy treated as a qualified joint interest under the following conditions:

1) Before January 1, 1977, a husband and wife had a joint interest in property with right of survivorship;
2) After December 31, 1976, the joint interest is terminated; and
3) After December 31, 1976, a joint interest of the husband and wife was created in that property (or in other property the basis of which wholly or partly reflects the basis of the property in (1)).

Treatment as a qualified joint interest will only be available ***after 1979***, if you sever and re-create the interest and file a gift tax return for the quarter in which the re-creation occurs.

Election to treat certain jointly held property as eligible joint interest. For jointly held property used as a farm or for farming purposes (as defined in Section 8(G)) or for any other trade or business, an election may be made, ***for the estates of individuals who die after 1978,*** to reduce the value of such interest, includible in the gross estate, by the sum of:

1) The excess of the value of the eligible joint interest at the date of the decedent's death over the total adjusted consideration furnished by the decedent and the decedent's spouse, ***multiplied by*** 2% for each tax year (up to 50%) in which the surviving spouse materially participated in the operation of the farm or other trade or business; and
2) Any adjusted consideration furnished by the decedent's spouse.

This reduced value treatment is allowable only if the estate timely elects to have it apply to such interest. The election must be made no later than the time for filing the estate tax return (including extensions).

Limitations. If this election is made, at least 50% of the value of the eligible joint interest must be included in the gross estate. The overall reduction under this election is limited to $500,000. In addition, the election does not apply if the adjusted consideration provided by both spouses equals or exceeds the value of the property at the individual's death. See the explanation of adjusted consideration later in this discussion.

Material participation means participation like that which would make a person liable for self-employment tax.

Eligible joint interest is any interest in property held by the decedent and the decedent's spouse as joint tenants or as tenants by the entirety, but only if:

1) Such joint interest was created by the decedent, the decedent's spouse, or both; and
2) In a joint tenancy, only the decedent and the decedent's spouse are joint tenants.

Adjusted consideration, as used in this discussion, means the sum of:

1) The consideration furnished by the individual concerned, as determined under the rules described earlier, but not any consideration such as income or gain from the business which includes such property; and
2) An amount equal to that interest which the consideration, described in (1), would have earned over the period in which it was invested in the farm or other business, if it had been earning interest throughout such period at 6% simple interest.

Jointly owned property is listed on Schedule E, Form 706.

Real property that the decedent held as a tenant in common is listed on Schedule A, Form 706.

H) Powers of Appointment

The gross estate includes the value of property interests over which the decedent had a general power of appointment at death. The existence of the power does not depend on the capacity of the decedent to exercise the power. Included is the value of property interests over which the decedent exercised or released such a power during lifetime if the exercise or release was:

1) Within 3 years of death (as described in *J) Transactions Within 3 Years of Death*); or
2) With a retained life interest in the property appointed (as described in *C) Transfers with Retained Life Estate*); or
3) With a retained reversionary interest in the property appointed (as described in *D) Transfers Taking Effect at Death*); or
4) With a retained power to alter, amend, revoke, or terminate the appointment (as described in *E) Revocable Transfers*).

There are different rules for including property subject to a general power of appointment if the power was created before October 22, 1942. These are discussed later.

Power of appointment. A power of appointment determines who will own or enjoy, now or later, the property subject to the power. The power must be created by another and does not include a power created or held by the decedent when that individual transferred owned property. The term ***power of appointment*** includes all powers that are, in substance and effect, powers of appointment regardless of the wording used in a particular legal document and regardless of local property law.

Example. If the property laws of a state give the wife a power of testamentary disposition over property to which she does not have a vested title, she is considered to have a power of appointment for federal estate tax purposes.

It should be noted that there are some powers that do not in themselves constitute a power of appointment. A power to amend only administrative provisions of a trust that cannot substantially affect the beneficial enjoyment of the trust property or income would not be considered a power of appointment; nor would a power to manage, invest, or control assets, or allocate receipts and disbursements, when exercised only in a fiduciary capacity.

General power of appointment. A general power of appointment is one in which decedents could have appointed the property subject to the power to themselves, their creditors, their estates, or their estates' creditors. It includes the unlimited power to use either income or corpus, or both, for the decedent's benefit. Thus, if a decedent received the power to appoint the corpus of a trust to any of six persons not including the decedent, but also received the power to invade corpus for any reason for the decedent's own benefit, the decedent would have a general power of appointment. However, a power of the decedent to consume or invade for the decedent's own benefit, ***limited by an ascertainable standard*** relating to health, education, support or maintenance, is ***not*** considered a general power of appointment.

Example. If the power to appoint the corpus of a trust were given to the decedent, Michael Elm, and he could appoint any of six persons not including himself, and could also invade the corpus for his own reasonable support, education, and medical expenses, the power would not be considered a general power of appointment. A power to use property for the ***comfort, welfare, or happiness*** of the decedent is ***not*** an ascertainable standard and therefore is a general power of appointment.

The decedent is not considered to have had a general power of appointment if the power could be used only with the consent or joinder of the creator of the power, or a person having a substantial adverse interest in the property subject to the power. A trustee administering a trust in a fiduciary capacity, by that fact alone, does not have an adverse interest in the trust.

In order for a power of appointment to qualify as a general power it must be exercisable in favor of the decedent, his or her estate, or the creditors of the decedent (or of the estate). A power of appointment is not a general power if, by its terms, it is either exercisable only in favor of one or more designated persons other than the decedent, or the decedent's creditors, or the decedent's estate or creditors of the decedent's estate, or is expressly not exercisable in favor of the decedent, or the decedent's creditors, or the decedent's estate or the creditors of the decedent's estate.

Property interests subject to a general power of appointment are includible in the gross estate if a decedent held that power at death, or had previously exercised or released the power in a way that, if it had been a transfer of the decedent's own property, it would have been included in the gross estate as a transfer within 3 years of death, a transfer with a retained life estate, a transfer taking effect at death, or a revocable transfer.

Example. If the decedent had been given a general power of appointment over Blackacre, a farm, and had exercised the power in favor of his son, but retained the use of Blackacre for himself for life, the value of Blackacre would be included in the decedent's gross estate.

Right under the Uniform Gifts to Minors Act. If under the Uniform Gift to Minors Act the decedent-parent has a right to petition a court to order the custodian of property, transferred pursuant to the Act by a person other than the decedent, to apply the property for the child's benefit, the right to petition the court does not constitute a general power of appointment. The value of such custodial property is not includible in the decedent-parent's gross estate.

Property subject to the power is not included in a gross estate if the decedent released the power completely (and not within 3 years of death) and if the decedent held no interest in or control over such property. If the failure to exercise a general power of appointment results in a lapse of the power, the lapse is treated as a release only to the extent that the value of the property that could have been appointed by the exercise of the lapsed power is more than the greater of either $5,000 or 5% of the total value, at the time of the lapse, of the assets, or proceeds, out of which the exercise of the lapsed power could have been satisfied.

In contrast to a release, if a decedent had disclaimed or renounced a general power of appointment, the property is not included in the gross estate. A disclaimer is a complete and unqualified ***refusal to accept*** the power of appointment. There can be no disclaimer of a power after it has once been accepted, and the disclaimer must be effective under local law.

The surviving spouse's nonexercise of the right to take a statutory share in lieu of the share provided in the decedent spouse's will is a complete disclaimer of that right by operation of law.

General powers of appointment created before October 22, 1942, are generally subject to the rules explained above. However, if a decedent held such a power at the time of death, it is included in the gross estate only if exercised. Such a power is not included in the gross estate if the decedent released it either during life or at death, or allowed it to lapse. Also, a power created before October 22, 1942, and given to the decedent but exercisable only in conjunction with another person, regardless of adverse interest, is not treated as a general power of appointment.

A power of appointment created by will is generally considered created on the date of the creator's death. However, a power of appointment created by a will, executed on or before October 21, 1942, is considered as created by that date if the creator died before July 1, 1949, without having republished the will by codicil or otherwise after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. Such power is not considered as created at some future date merely because it is not exercisable immediately, because it is revocable, or because the identity of its holders is not ascertainable until after the date the instrument takes effect. However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first.

Property subject to a general power of appointment that is includible in the gross estate is listed on Schedule H, Form 706.

I) Proceeds of Life Insurance

The gross estate includes the proceeds of life insurance ***on the decedent's life*** if:

1) The proceeds are receivable by the estate; or
2) The proceeds are receivable by another for the benefit of the estate; or
3) The decedent possessed ***incidents of ownership*** in the policy.

Life insurance ***on the life of another,*** owned by the decedent at the decedent's death, is included in the gross estate as ***property owned at death,*** as discussed earlier in *A) Property Owned by the Decedent.* The amount includible is the replacement value of the policy. When the replacement value is not readily ascertainable, the value of the policy may be approximated by adding the interpolated terminal reserve at the date of death and a proportionate share of the last premium paid.

The term ***life insurance*** refers to life insurance of every description including:

1) Whole life policies;
2) Term insurance;
3) Group life insurance;
4) Double indemnity, travel, and accident insurance;
5) Endowment contracts (before being paid up); and
6) Death benefits paid by fraternal societies operating under the lodge system.

The term life insurance, however, does not include:

1) Refunds of premiums in case of suicide; and
2) No-risk, single-premium policies combining annuities and life insurance.

Proceeds of insurance on the life of the decedent receivable by the executor or administrator, or payable to the decedent's estate, are included in the gross estate. It is not necessary that the estate be specifically named as the beneficiary.

If the proceeds of a policy are receivable by an individual beneficiary and these proceeds are subject to an obligation, legally binding upon the beneficiary, to pay taxes, debts, or other charges enforceable against the estate, the proceeds required for payment of the taxes, etc., are includible in the decedent's gross estate to the extent of the beneficiary's obligation.

Proceeds of insurance on the life of a decedent, not receivable by or for the benefit of the estate, are includible if the decedent held, at death, any of the ***incidents of ownership*** in the policy, exercisable either alone or together with any other person, even if the decedent was acting as a trustee. In this context, the term ***incidents of ownership*** does not mean only the ownership of the policy in a technical, legal sense. Generally, the term refers to the right of the insured or the insured's estate to the economic benefits of the policy. It includes the power to change beneficiaries, to revoke an assignment, to obtain a loan against the surrender value, to pledge the policy for a loan, or to surrender or cancel the policy. Rights that are not considered to be incidents of ownership include the right to receive dividends and the right to veto the sale by a trustee of an irrevocable funded insurance trust.

Example. In 1966 the decedent, Bob Gray, purchased an insurance policy on his life and named his wife beneficiary. In 1971 Bob transferred complete ownership of the policy to his wife and also named their children as beneficiaries. In 1974 his wife died and in his wife's will, Bob was named executor of his wife's estate and the trustee of a residuary trust established for the children. The insurance policy on Bob's life was included in his wife's residuary estate.

As trustee, Bob was granted absolute discretion to distribute the current income to the beneficiaries or accumulate the income and add it to the corpus. Also, Bob was empowered in the management and investment of the trust property to do anything with the property as if it were his own. Under the terms of the policy, the owner could elect to have the proceeds made payable according to various plans, use the loan value to pay the premiums, borrow on the policy, assign or pledge the policy, and elect to receive the annual dividends.

Bob died in 1977, and the proceeds of the policy were included in his gross estate since he possessed an incident of ownership in the policy. Although he held the policy in a fiduciary capacity, his control was an incident of ownership, since he, as trustee, had the right to elect optional modes of settlement and borrow on the policy under the terms of the trust and insurance. Simply, he had a substantial degree of control over the time and the enjoyment of the policy proceeds.

A group life insurance policy taken out by an employer on the decedent's life is included in the gross estate if the decedent (employee) owned the right to change the beneficiaries, the right to terminate the policy, or the right to prevent cancellation by purchasing the policy. However, the power to terminate the policy solely by ending employment is not an incident of ownership and the value of the proceeds is not included in the insured's gross estate. Further, if the employee had the right to convert a group policy into an individual insurance policy at the end of employment (and such a right was transferable), the proceeds of the policy are not included in the gross estate if the decedent irrevocably assigned both the policy and the conversion privilege to another. In such a case, the assignee's right to the proceeds could not have been defeated by any action of the decedent and, therefore, the decedent had no control or ***incidents of ownership*** over the policy.

If a policy is included in an estate because a decedent held an incident of ownership over it, it is immaterial that the decedent did not initially take out the policy, or that the decedent was ***physically*** unable to exercise control over the policy at the time of death.

The term ***incidents of ownership*** also includes a reversionary interest in the policy or its proceeds, whether arising by the express terms of the policy or other instrument or by operation of law, but only if the value of the reversionary interest immediately before the death of the decedent was more than 5% of the value of the policy. As used in this context, the term ***reversionary interest*** includes two possibilities:

1) That the policy or its proceeds may return to the decedent or the decedent's estate; and
2) That the policy or its proceeds may become subject to a power of disposition by the decedent. See Section 8(E), *Annuities, Life Estates, Terms for Years, Remainders, and Reversions,* in this Part for the method of determining the value of a reversionary interest.

Insurance proceeds paid to a divorced spouse. Life insurance proceeds paid directly to a decedent's spouse are includible in a decedent's gross estate if, under a decree of divorce, the decedent was required to name the divorced spouse as beneficiary of certain life insurance policies on the decedent's life and was obligated to maintain the policies until the former spouse's death or remarriage. However, a deduction is allowed from the gross estate as an indebtedness of the estate.

Example. Under the terms of a divorce decree by a court with power under local law to decree a settlement of all marital property rights, John Black was required to name his wife as beneficiary of certain life insurance policies on his life. John was required to keep the policies in full force and effect until his death.

If John's wife remarries or dies prior to his death, the policy proceeds would return to John, his estate, or be subject to a power of disposition. Thus, before death John held a reversionary interest that was more than 5% of the policies' value.

After John's death, the proceeds were paid directly to John's former wife and never became part of the probate estate.

Since before death John held a reversionary interest of more than 5% of the value of the policies, the interest was an incident of ownership in the policies, and the value of the proceeds is includible in John's gross estate.

The terms ***reversionary interest*** and ***incidents of ownership*** do not apply to a policy or its proceeds that the decedent might receive by inheritance through the estate of another person, or as a surviving spouse under a statutory right of election or similar right.

Proceeds of life insurance that are not includible in the gross estate under the provisions, just discussed, may, depending on the facts, be includible under other provisions discussed in this section.

Example. If the decedent held incidents of ownership in a policy on the decedent's life but gratuitously transferred all rights in the policy within 3 years of death, the proceeds are includible under the provisions discussed later in *J) Transactions Within 3 Years of Death.*

The proceeds of life insurance on the decedent's life includible in the gross estate should be listed on Schedule D, Form 706. A copy of Form 712, *Life Insurance Statement,* prepared by the insurance company, should accompany the return for each policy included.

J) Transactions Within 3 Years of Death

The value of property transferred by the decedent after 1976 during the 3-year period ending on the date of the decedent's death is includible in the decedent's gross estate, regardless of the donor's intent.

Exception. The rule does not apply to:

1) Any bona fide sale for an adequate and full consideration in money or money's worth; and

2) Any gift (other than a life insurance policy) made to a donee during a calendar year if the decedent was not required to file a gift tax return with respect to the donee because gifts to that donee did not exceed the $3,000 annual exclusion for the calendar year.

Special election for gifts made in 1977. For any gifts (other than a life insurance policy) made to a donee during 1977 and that were made within 3 years of death, the executor may elect to include in the gross estate only the value of the gift at the date of death to the extent that it exceeds $3,000. This election must be made on or before the due date for filing the estate tax return (including extensions), OR July 30, 1980, whichever is later. If the special election is made, it applies to all gifts made in 1977 and that were made within 3 years of death.

Note. The inclusion of a completed gift in the decedent donor's estate could cause a recomputation of the donee's basis. This computation is discussed in Section 17, *Recipient's Basis in Gifts,* of Part II.

If a decedent made a completed gift of a life insurance policy on his or her life within 3 years of death, the proceeds of the life insurance policy are included in the gross estate of the decedent.

Gross-up of gift taxes. The amount of the gross estate also is increased by the amount of any gift tax paid by the decedent, or the estate of the decedent, on any gift made by the decedent (or the decedent's spouse) after 1976 and during the 3-year period ending on the date of the decedent's death.

The value of the transfers within 3 years of death, including the gift tax thereon, is listed on Schedule G, Form 706.

8. Valuation

Generally, the value of the decedent's property interest for estate tax purposes is its fair market value at the date of death (or at the alternate valuation date if elected by the executor or administrator—see *F) Alternate Valuation,* later). Real property used in farming or other closely held businesses is eligible for a reduced valuation for estate tax purposes if the executor or administrator so elects. This special valuation is discussed in *G) Special Farm or Other Closely Held Business Real Property Valuation.*

The ***fair market value*** is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. The fair market value may not be determined by a forced sale price, nor is it to be determined by the sale price of the item in a market other than that in which the item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item that is generally retailed, the fair market value is the price at which the item or a comparable item would be sold at retail.

Example. An automobile generally is retailed, and its fair market value therefore would be its retail value. The price a used car dealer would pay may not be used. If tangible personal property is sold as the result of an advertisement in the classified section of a newspaper, and the property is of a type often sold by this means, or the property is sold at a public auction, the price for which it is sold will be presumed to be the retail sales price of the item at the time of the sale. This retail sales price also will be presumed to be the retail sales price of the item on the applicable valuation date if the sale is made within a reasonable period following the applicable valuation date and there is no substantial change in market conditions or other circumstances affecting the value of similar items between the time of the sale and the applicable valuation date.

The following set forth rules governing the valuation of particular types of property.

A) Unimproved Real Property

Unimproved real property is defined as land without significant buildings, structures, or any other improvements that contribute to its value.

Generally, the best indication of the value of unimproved real property is the price paid for the property in an arm's-length transaction on or prior to the valuation date. When the property has not recently been the subject of an arm's-length transaction, the best method of estmating the value of unimproved real property is by use of the market data or comparable sales approach. This approach uses arm's-length sales of properties that show the most similar characteristics to the property being valued.

The comparable sales method involves a comparison of the subject property with several similar properties that have been sold. The sales prices, as adjusted for differences in date of sale, size, condition, and location, would then reflect the estimated fair market value of the subject property.

When the comparable sales method is used, consider the following factors during the inspection of the potential comparable property and the subject property:

1) Location, configuration, restrictions as to use or zoning;
2) Accessibility and road frontage, available utilities and water rights;
3) Riparian rights, existing easements, rights of way, leases, etc.;
4) Soil characteristics, vegetative cover, status of mineral rights; and
5) Other factors affecting value.

In addition, the names of the buyer and seller, the deed book and page number, the date of sale, sale price, property description, amount and terms of mortgages, property surveys, the assessed value, tax rate, and the assessor's appraised fair market value of the comparable properties should be indicated.

The potential comparable sale price must be adjusted to account for differences between the sale property and the subject property. Since differences of opinions may arise as to the degree of comparability and the amount of the adjustment deemed necessary for comparison purposes, document each item of adjustment.

Only comparable sales having the least adjustments in terms of items and/or total dollar adjustments should be considered as comparable to the subject property.

B) Stocks and Bonds

The value of stocks and bonds is their fair market value per unit on the applicable valuation date.

If there is a market for stocks and bonds on a stock exchange, in an over-the-counter market, or otherwise, the mean (midpoint) between the highest and lowest quoted selling prices on the valuation date is the fair market value per unit. If there were no sales on the valuation date, but there were sales on dates within a reasonable period before and after the valuation date, the fair market value is determined by taking a weighted average of the means between the highest and lowest sales prices on the nearest date before, and the nearest date after, the valuation date. The average is to be weighted ***inversely*** by the respective numbers of trading days between the selling dates and the valuation date.

Example. The nearest transactions took place 2 trading days before the valuation date at a mean selling price of $10 and 3 trading days after the valuation date at a mean selling price of $15. The price of $12 is the fair market value, obtained by the following computation:

$$\frac{(3 \times \$10) + (2 \times \$15)}{5} = \$12$$

If no transactions occurred within a reasonable period before and after the valuation date, the fair market value may be determined by taking a weighted average of the means between the bona fide bid and asked prices on the nearest trading date before, and the nearest trading date after, the valuation date, if both such nearest dates are within a reasonable period.

If the highest and lowest selling prices on the valuation date are not available for bonds for which there is a market on the stock exchange, but the closing selling prices are available on the valuation date and the trading day before the valuation date, then the fair market value of the bond is the mean between the quoted closing selling price on the valuation date and the quoted closing selling price on the trading day before the valuation date.

If the stocks or bonds are listed on more than one exchange, the records of the ex-

change where the stocks or bonds are principally dealt in should be used to value the stocks and bonds if the records are available in a generally available listing or publication of general circulation. If these records are not available and the stocks and bonds are in a composite listing of combined exchanges in a generally available listing or publication of general circulation, then the records of the combined exchanges should be used.

If no actual sale prices or bona fide bid and asked prices are available on a date within a reasonable period before the valuation date, but are available on a date within a reasonable period after the valuation date, or vice versa, then the mean between the highest and lowest available sale prices or bid and asked prices on that date may be taken as the fair market value.

Closely held corporation. If selling prices or bid and asked prices are not available under the foregoing conditions, or if securities of a closely held corporation are involved, the fair market value is to be determined by taking the following factors into consideration:

1) In the case of bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and
2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.

Some of the ***other relevant factors*** are the goodwill of the business, the economic outlook in the particular industry, the company's position in the industry, the degree of control represented by the block of stock to be valued, and the value of securities of other corporations engaged in the same or similar lines of business that are listed on a stock exchange.

Shares of stock in a closely held corporation that an individual transferred within 3 years of death and shares of such stock that he or she retained are treated as one block of shares in determining the degree of control represented by the shares.

Stock selling ex-dividend. If a dividend was declared before the valuation date, payable after that date, and the stock was selling ex-dividend on the valuation date, the amount of the dividend is added to the ex-dividend quotation to determine the fair market value of the stock. If the decedent died on a weekend and the stock began selling ex-dividend on the following trading day the value of the dividend must be added to the amount of the ex-dividend quotation for purposes of determining the weighted average.

Restricted securities. Some securities cannot be immediately resold by the holder because they are restricted from resale pursuant to federal securities laws. The securities are sometimes called "restricted securities," "unregistered securities," "investment letter stock," or "private placement stock."

Valuation. In valuing restricted shares, the securities industry uses the following methods to determine the fair market value.

1) Current market price of the unrestricted stock less a constant precentage ***discount*** based on purchase discount;
2) Current market price of unrestricted stock less a constant percentage ***discount*** different from purchase discount;
3) Current market price of the unrestricted stock less a ***discount*** amortized over a fixed period;
4) Current market price of the unrestricted stock; and
5) Cost of the restricted stock until it is registered.

Discount. The following factors are considered in determining the amount of discount mentioned above. In using the factor, some may carry more weight than others.

1) Earnings, net assets and net sales must be given primary consideration in arriving at the discount for restricted securities from freely traded shares. Depending on the type of business activity, one of the elements may be given more weight than others.
2) Resale provisions found in the restriction agreements must be weighed to determine the discount to apply to the fair market value of the company. For instance, the longer a buyer of shares must wait to liquidate the stock, the greater the discount.
3) The negotiation strengths of the buyer and seller affect the amount of the discount. For instance, a tight money market may cause the buyer to have the better bargaining position.
4) The market experience of freely tradable securities of the same class as the restricted securities is significant in determining the discount. For instance, shares traded on a public market generally are worth more to investors than those that are not traded on a public market.

All relevant facts and circumstances that bear upon the worth of restricted stock, including those set forth above, are taken into account in arriving at the fair market value of the securities.

C) Shares in Mutual Funds

The value of a share in an open-end investment company (commonly known as a mutual fund) is the redemption price (known as the bid price) on the date of death, or alternate valuation date. If there is no public redemption price quoted by the company for the applicable valuation date, the fair market value of the mutual fund share is the last public redemption price quoted by the company for the first day preceding the applicable valuation date for which there is a quotation.

D) Interest in Business

The fair market value of any interest of a decedent in a business, whether a sole proprietorship or a partnership, is the net amount that a willing purchaser would pay for the interest to a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.

The net value is determined on the basis of all relevant factors including:

1) A fair appraisal of all the assets of the business;
2) The demonstrated earning capacity of the business; and
3) Other factors used in considering the value of corporate stock, to the extent applicable.

Special attention should be given to determining an adequate value of the goodwill of the business in all cases in which the decedent has not agreed, for an adequate and full consideration in money or money's worth, that the interest passes at death to, for example, a surviving partner or partners. Complete financial and other data supporting this valuation must be submitted with the return.

E) Annuities, Life Estates, Terms for Years, Remainders, and Reversions

The value of an annuity, or of a life insurance policy on the life of a person other than the decedent, issued by a company regularly engaged in the selling of such contracts, is the amount that the issuing company would charge for a comparable contract on the date of the decedent's death.

An annuity payable under a combination annuity and life insurance policy on a decedent's life, which had no insurance element at the time of the decedent's death, is treated simply as a contract for the payment of an annuity.

An insurance policy on a decedent's life that is includible in the gross estate, as described in Section 7(I), *Proceeds of Life Insurance,* has a value equal to the proceeds payable by the policy.

The value of all annuities, life estates, terms for years, remainders, or reversions other than those already described, is the ***present value*** on the applicable valuation date.

To compute the present value of an annuity, life estate, remainder, or reversion that is dependent upon the continuation or termination of any one life, Table A should be used. For purposes of the table, the age of a person is the age attained at the birthday nearest to the valuation date. This table is used only if the decedent died after 1970, and if just one life is involved. If the rights to be valued depend upon the lives of two or more persons, other tables must be used.

These tables are shown in the following Internal Revenue publications:

Publication 723, *Valuation of Last Survivor Charitable Remainders;*

Publication 723A, *Factors at 6 Percent Involving One and Two Lives;*

Supplement 1 to Publication 723A;

Publication 723B, *Two-Life Tables for Unitrusts and Pooled Income Funds.*

These publications are available from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402.

Supplement 1 to Publication 723A contains factors for valuing a spouse's rights in a tenancy by the entirety, where each spouse is entitled to one-half the income while both are living. Also, it provides a table for evaluating the present worth of the right to receive the use of $1.00 for a term of 10 to 11 years or until the prior death of a person (male or female) of stated age.

Publication 723B contains two-life, last-to-die factors for valuing the remainder interest in charitable remainder unitrusts and pooled income funds. The adjusted payout rates for the unitrusts range from 4.6% to 12.4% in intervals of 0.2%. The yearly rates of return for pooled income funds extend from 2.2% to 10.0% in intervals of 0.2%. Both tables give all possible combinations for males and females from ages 30 through 90.

For two-life situations not covered in Publication 723B, or for three or more lives, the method and tables shown in Publication 723 should be used. The Internal Revenue Service may, if conditions permit, supply the factor upon request. See Part IV for the procedure for requesting actuarial factors.

The annuity factors in Table A, and any annuity factors derived from the other publications, should be used unmodified only if payments are made annually at the end of each year. If an annuity is payable at the end of semiannual, quarterly, monthly, or weekly periods during the life of an individual or for a term of years, the annual amount to be paid is multiplied by the annuity factor. The result is then multiplied by whichever of the following factors applies:

1.0148 for semiannual payments;
1.0222 for quarterly payments;
1.0272 for monthly payments; or
1.0291 for weekly payments.

If the property interest depends on a term certain rather than on a life or lives, its present value is computed using Table B. If payments are made semiannually, quarterly, monthly, or weekly, rather than annually, the adjustment factors shown in the preceding paragraph must be used.

If the first payment of an annuity certain (no lives involved) is due at the ***beginning*** of the annual period or other payment period, the annual amount to be paid is multiplied by the appropriate annuity factor from Table B. The result then is multiplied by whichever of the following factors applies:

1.0600 for annual payments;
1.0448 for semiannual payments;
1.0372 for quarterly payments;
1.0322 for monthly payments; or
1.0303 for weekly payments.

F) Alternate Valuation

The executor may elect to use the alternate valuation method. This provides for the valuation of the property included in the decedent's gross estate as of a date other than that of death. Such an election does not change the rule that the gross estate includes property that the decedent owned, or in which the decedent had an interest, on the date of death. The election must be made on the estate tax return, filed within 9 months of the date of death or within the period of any extension of time granted for filing such return. (See Section 4, *Extension of Time to File the Return.*)

The purpose of this method is to permit a reduction of the tax liability if there is a shrinkage in the aggregate value of the estate's property. However, the method may be used whether or not a shrinkage has occurred. The election, however, is not effective for any purpose unless a return is required to be filed. In any event, the ***election applies to all of the property in the estate.*** It cannot be used for only a portion of such property.

If the alternate valuation method is elected, then any deduction is allowed only to the extent that it is not otherwise allowed in determining the value of the gross estate.

Example. If a charitable deduction is expressed as a percentage of the gross estate, the alternate value of the gross estate would be used in computing the charitable deduction. No election may be made, or previous election changed, after the expiration of the period provided for its exercise.

Alternate valuation rules. The alternative valuation method is used according to the following rules:

1) Any property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date on which it is first distributed, sold, exchanged, or otherwise disposed of;
2) Any property not distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of 6 months after the date of the decedent's death;
3) Any property, interest, or estate that is affected by mere lapse of time is valued as of the date of the decedent's death, but adjusted for any difference in its value not due to mere lapse of time as of 6 months after the decedent's death, or as of the date of its distribution, sale, exchange, or other disposition, whichever date occurs first.

Properties, interests, or estates that are ***affected by mere lapse of time*** include patents, estates for the lives of persons other than the decedent, remainders, and reversions. This phrase has no reference to obligations for the payment of money, whether or not interest bearing, the value of which changes with the passing of time. Following are examples of the operation of rule 3.

Example 1. Al Brown has a life estate in certain property, that is, the right to receive the income from the property for his life. Al's brother Bob had a remainder interest in fee in the same property, that is, Bob or his estate was to receive the property after Al's death.

Bob died when Al was 31 years old, calculated to his nearest birthday. On the date of Bob's death, the fair market value of the property was $50,000. The value of the remainder interest in this property is includible in Bob's gross estate.

The value of the estate's remainder interest in this property is computed using the factor taken from Table A for remainder interests (column 4) for males, age 31. This factor is .13883.

If the executor does not elect the alternate valuation date, the value of the remainder interest in the property for estate tax purposes is $6,941.50 ($50,000 × .13883).

If the executor elects the alternate valuation date and because of economic conditions the property declined $10,000 in value, the value of the remainder interest would be $5,553.20 ($40,000 × .13883) even though Al may be 32 years old on the alternate valuation date.

Example 2. Bernard Jones owned a patent that had a value at the date of his death of $78,000 and an unexpired term of 10 years. Three months after Bernard's death, the patent was sold, because of the lapse of time and other factors, for $60,000. To determine the value of the patent includible in the gross estate under the alternate valuation method, an adjustment to the selling price must be made to reflect the change in value attributable solely to the lapse of 3 months. This alternate value is obtained by dividing $60,000 by .975 (the ratio of the remaining life of the patent on the valuation date (9.75 years) to the remaining life at the date of death (10 years)). Thus, the includible amount is $61,538.46. Note that Tables A and B were not used for this computation.

Mutual fund capital gain dividends. A capital gain dividend declared and paid by a regulated investment company on its stock between the date of the decedent's death, and the alternate valuation date is not includible in computing the value of the decedent's gross estate on the alternate valuation date. This rule applies if the value of the shares of the stock on the alternate valuation date ***reasonably represent*** the same included property of the gross estate as existed at the date of the decedent's death.

G) Special Farm or Other Closely Held Business Real Property Valuation

If certain conditions are met, the executor or administrator of an estate may elect to value qualified real property, which is included in the decedent's estate and which is devoted to farming, or is used in a closely held business, on the basis of its actual use

Table A

Male				Female			
1 Age	2 Annuity	3 Life Estate	4 Remainder	1 Age	2 Annuity	3 Life Estate	4 Remainder
0	15.6175	.93705	.06295	0	15.8972	.95383	.04617
1	16.0362	.96217	.03783	1	16.2284	.97370	.02630
2	16.0283	.96170	.03830	2	16.2287	.97372	.02628
3	16.0089	.96053	.03947	3	16.2180	.97308	.02692
4	15.9841	.95905	.04095	4	16.2029	.97217	.02783
5	15.9553	.95732	.04268	5	16.1850	.97110	.02890
6	15.9233	.95540	.04460	6	16.1648	.96989	.03011
7	15.8885	.95331	.04669	7	16.1421	.96853	.03147
8	15.8508	.95105	.04895	8	16.1172	.96703	.03297
9	15.8101	.94861	.05139	9	16.0910	.96541	.03459
10	15.7663	.94598	.05402	10	16.0608	.96365	.03635
11	15.7194	.94316	.05684	11	16.0293	.96176	.03824
12	15.6698	.94019	.05981	12	15.9958	.95975	.04025
13	15.6180	.93708	.06292	13	15.9607	.95764	.04236
14	15.5651	.93391	.06609	14	15.9239	.95543	.04457
15	15.5115	.93069	.06931	15	15.8856	.95314	.04686
16	15.4576	.92746	.07254	16	15.8460	.95076	.04924
17	15.4031	.92419	.07581	17	15.8048	.94829	.05171
18	15.3481	.92089	.07911	18	15.7620	.94572	.05428
19	15.2918	.91751	.08249	19	15.7172	.94303	.05697
20	15.2339	.91403	.08597	20	15.6701	.94021	.05979
21	15.1744	.91046	.08954	21	15.6207	.93724	.06276
22	15.1130	.90678	.09328	22	15.5687	.93412	.06588
23	15.0487	.90292	.09702	23	15.5141	.93085	.06915
24	14.9807	.89884	.10116	24	15.4565	.92739	.07261
25	14.9075	.89445	.10555	25	15.3959	.92375	.07625
26	14.8287	.88972	.11028	26	15.3322	.91993	.08007
27	14.7442	.88465	.11535	27	15.2652	.91591	.08409
28	14.6542	.87925	.12075	28	15.1946	.91168	.08832
29	14.5588	.87353	.12647	29	15.1208	.90725	.09275
30	14.4584	.86750	.13250	30	15.0432	.90259	.09741
31	14.3528	.86117	.13883	31	14.9622	.89773	.10227
32	14.2418	.85451	.14549	32	14.8775	.89265	.10735
33	14.1254	.84752	.15248	33	14.7888	.88733	.11267
34	14.0034	.84020	.15980	34	14.6960	.88176	.11824
35	13.8758	.83255	.16745	35	14.5989	.87593	.12407
36	13.7425	.82455	.17545	36	14.4975	.86985	.13015
37	13.6036	.81622	.18378	37	14.3915	.86349	.13651
38	13.4591	.80755	.19245	38	14.2811	.85687	.14313
39	13.3090	.79854	.20146	39	14.1663	.84998	.15002
40	13.1538	.78923	.21077	40	14.0468	.84281	.15719
41	12.9934	.77960	.22040	41	13.9227	.83536	.16464
42	12.8279	.76967	.23033	42	13.7940	.82764	.17236
43	12.6574	.75944	.24056	43	13.6604	.81962	.18038
44	12.4819	.74891	.25109	44	13.5219	.81131	.18869
45	12.3013	.73808	.26192	45	13.3781	.80269	.19731
46	12.1158	.72695	.27305	46	13.2290	.79374	.20626
47	11.9253	.71552	.28448	47	13.0746	.78448	.21552
48	11.7308	.70385	.29615	48	12.9147	.77488	.22512
49	11.5330	.69198	.30802	49	12.7496	.76498	.23502
50	11.3329	.67997	.32003	50	12.5793	.75476	.24524
51	11.1308	.66785	.33215	51	12.4039	.74423	.25577
52	10.9267	.65560	.34440	52	12.2232	.73339	.26661
53	10.7200	.64320	.35680	53	12.0367	.72220	.27780
54	10.5100	.63060	.36940	54	11.8436	.71062	.28938
55	10.2960	.61776	.38224	55	11.6432	.69859	.30141

Table A

Male				Female			
1 Age	2 Annuity	3 Life Estate	4 Remainder	1 Age	2 Annuity	3 Life Estate	4 Remainder
56	10.0777	.60466	.39534	56	11.4353	.68612	.31388
57	9.8552	.59131	.40869	57	11.2200	.67320	.32680
58	9.6297	.57778	.42222	58	10.9980	.65988	.34012
59	9.4028	.56417	.43583	59	10.7703	.64622	.35378
60	9.1753	.55052	.44948	60	10.5376	.63226	.36774
61	8.9478	.53687	.46313	61	10.3005	.61803	.38197
62	8.7202	.52321	.47679	62	10.0587	.60352	.39648
63	8.4924	.50954	.49046	63	9.8118	.58871	.41129
64	8.2642	.49585	.50415	64	9.5592	.57355	.42645
65	8.0353	.48212	.51788	65	9.3005	.55803	.44197
66	7.8060	.46836	.53164	66	9.0352	.54211	.45789
67	7.5763	.45458	.54542	67	8.7639	.52583	.47417
68	7.3462	.44077	.55923	68	8.4874	.50924	.49076
69	7.1149	.42689	.57311	69	8.2068	.49241	.50759
70	6.8823	.41294	.58706	70	7.9234	.47540	.52460
71	6.6481	.39889	.60111	71	7.6371	.45823	.54177
72	6.4123	.38474	.61526	72	7.3480	.44088	.55912
73	6.1752	.37051	.62949	73	7.0568	.42341	.57659
74	5.9373	.35624	.64376	74	6.7645	.40587	.59413
75	5.6990	.34194	.65806	75	6.4721	.38833	.61167
76	5.4602	.32761	.67239	76	6.1788	.37073	.62927
77	5.2211	.31327	.68673	77	5.8845	.35307	.64693
78	4.9825	.29895	.70105	78	5.5910	.33546	.66454
79	4.7469	.28481	.71519	79	5.3018	.31811	.68189
80	4.5164	.27098	.72902	80	5.0195	.30117	.69883
81	4.2955	.25773	.74227	81	4.7482	.28489	.71511
82	4.0879	.24527	.75473	82	4.4892	.26935	.73065
83	3.8924	.23354	.76646	83	4.2398	.25439	.74561
84	3.7029	.22217	.77783	84	3.9927	.23956	.76044
85	3.5117	.21070	.78930	85	3.7401	.22441	.77559
86	3.3259	.19955	.80045	86	3.5016	.21010	.78990
87	3.1450	.18820	.81130	87	3.2790	.19674	.80326
88	2.9703	.17872	.82178	88	3.0719	.18431	.81569
89	2.8052	.16831	.83169	89	2.8808	.17285	.82715
90	2.6536	.15922	.84078	90	2.7068	.16241	.83759
91	2.5162	.15097	.84903	91	2.5502	.15301	.84699
92	2.3917	.14350	.85650	92	2.4116	.14470	.85530
93	2.2801	.13681	.86319	93	2.2901	.13741	.86259
94	2.1802	.13081	.86919	94	2.1839	.13103	.86897
95	2.0891	.12535	.87465	95	2.0891	.12535	.87465
96	1.9997	.11998	.88002	96	1.9997	.11998	.88002
97	1.9145	.11487	.88513	97	1.9145	.11487	.88513
98	1.8331	.10999	.89001	98	1.8331	.10999	.89001
99	1.7554	.10532	.89468	99	1.7554	.10532	.89468
100	1.6812	.10087	.89913	100	1.6812	.10087	.89913
101	1.6101	.09661	.90339	101	1.6101	.09661	.90339
102	1.5416	.09250	.90750	102	1.5416	.09250	.90750
103	1.4744	.08846	.91154	103	1.4744	.08846	.91154
104	1.4065	.08439	.91561	104	1.4065	.08439	.91561
105	1.3334	.08000	.92000	105	1.3334	.08000	.92000
106	1.2452	.07471	.92529	106	1.2452	.07471	.92529
107	1.1196	.06718	.93282	107	1.1196	.06718	.93282
108	.9043	.05426	.94574	108	.9043	.05426	.94574
109	.4717	.02830	.97170	109	.4717	.02830	.97170

Table B

1 Number of Years	2 Annuity	3 Term Certain	4 Remainder	1 Number of Years	2 Annuity	3 Term Certain	4 Remainder
1	0.9434	.056604	.943396	31	13.9291	.835745	.164255
2	1.8334	.110004	.889996	32	14.0840	.845043	.154957
3	2.6730	.160381	.839619	33	14.2302	.853814	.146186
4	3.4651	.207906	.792094	34	14.3681	.862088	.137912
5	4.2124	.252742	.747258	35	14.4982	.869895	.130105
6	4.9173	.295039	.704961	36	14.6210	.877259	.122741
7	5.5824	.334943	.665057	37	14.7368	.884207	.115793
8	6.2098	.372588	.627412	38	14.8460	.890761	.109239
9	6.8017	.408102	.591898	39	14.9491	.896944	.103056
10	7.3601	.441605	.558395	40	15.0463	.902778	.097222
11	7.8869	.473212	.526788	41	15.1380	.908281	.091719
12	8.3838	.503031	.496969	42	15.2245	.913473	.086527
13	8.8527	.531161	.468839	43	15.3062	.918370	.081630
14	9.2950	.557699	.442301	44	15.3832	.922991	.077009
15	9.7122	.582735	.417265	45	15.4558	.927350	.072650
16	10.1059	.606354	.393646	46	15.5244	.931462	.068538
17	10.4773	.628636	.371364	47	15.5890	.935342	.064653
18	10.8276	.649656	.350344	48	15.6500	.939002	.060998
19	11.1581	.669487	.330513	49	15.7076	.942454	.057546
20	11.4699	.688195	.311805	50	15.7619	.945712	.054288
21	11.7641	.705845	.294155	51	15.8131	.948785	.051215
22	12.0416	.722495	.277505	52	15.8614	.951684	.048316
23	12.3034	.738203	.261797	53	15.9070	.954418	.045582
24	12.5504	.753021	.246979	54	15.9500	.956999	.043001
25	12.7834	.767001	.232999	55	15.9905	.959433	.040567
26	13.0032	.780190	.219810	56	16.0288	.961729	.038271
27	13.2105	.792632	.207368	57	16.0649	.963895	.036105
28	13.4062	.804370	.195630	58	16.0990	.965939	.034061
29	13.5907	.815443	.184557	59	16.1311	.967867	.032133
30	13.7648	.825890	.174110	60	16.1614	.969686	.030314

as a farm or its use in the closely held business, rather than its fair market value determined on any other basis. Property passing in trust and property owned indirectly through a corporation or partnership qualifies for this special valuation. However, this special use valuation cannot reduce the decedent's gross estate by more than $500,000.

Executors electing special use valuation of farm real property for estate tax purposes are not required to show that the property has a different or higher use other than farming.

The decedent at the time of death must have been a citizen or resident of the United States.

The time and manner of making the election is discussed later under *Election*. The discussion also covers protective elections.

Qualified Real Property

The real property must have been used for a qualified use, defined later, on the date of the decedent's death, and:

1) At least 50% of the adjusted value of the gross estate must consist of the adjusted value of real or personal property that was being used as a farm or in a closely held business and was acquired from, or passed from, the decedent to a qualified heir of the decedent;
2) At least 25% of the adjusted value of the gross estate must consist of the adjusted value of qualified farm or closely held business real property;
3) The qualifying real property must have been owned by the decedent or by a member of the decedent's family and used for a qualified use for periods totaling 5 years or more of the last 8 years immediately preceding the decedent's death; and
4) There must have been material participation in the operation of the farm or closely held business by the decedent or by a member of the decedent's family for periods totaling 5 years or more out of the 8 years immediately preceding the decedent's death.

For purposes of (1) and (2) the value of property is determined without regard to its special-use value, but is reduced for unpaid mortgages on, or any indebtedness in respect of, property where the full value of the decedent's interest therein (undiminished by such mortgage or indebtedness) is included in the value of the gross estate.

Material Participation

For the special valuation rules to apply, the deceased owner and/or a member of a owner's family must materially participate in the operation of the farm or other business. Whether the required material participation occurs is a factual determination, and the types of activities and financial risks which will support such a finding will vary with the type of ownership of both the property itself and of any business in which it is used. Passively collecting rents, salaries, draws, dividends, or other income from the farm or other business is not sufficient for material participation, nor is merely advancing capital and reviewing a crop plan or other business proposal and financial reports each season or business year.

Qualified real property. To qualify for the special use valuation, real property must pass from the decedent to a qualified heir or be acquired from the decedent by a qualified heir. The real property may be owned directly or may be owned indirectly through ownership of an interest in a corporation, a partnership, or a trust. However, real property is considered to be qualified real property only if a qualified heir receives or acquires a present interest in the property from the decedent. Where the ownership is indirect, however, the decedent's interest in the business also must qualify as an interest in a closely held business on the date of the decedent's death and

for sufficient other time (combined with periods of direct ownership) to equal at least 5 years of the 8-year period preceding the death. All specially valued property must be used in a trade or business.

Directly owned real property that is leased by a decedent to a separate closely held business is considered to be qualified real property, but only if the separate business qualifies as a closely held business with respect to the decedent on the date of his or her death and for sufficient other time (combined with periods during which the property was operated as a proprietorship) to equal at least 5 years of the 8-year period preceding the death. For example, real property owned by the decedent and leased to a farming corporation or partnership owned and operated entirely by the decedent and fewer than 15 members of the decedent's family is eligible for the special use valuation.

For the special use valuation, the term trade or business applies only to an active business such as a manufacturing, mercantile, or service enterprise, or to the raising of agricultural or horticultural commodities, as distinguished from passive investment activities. The mere passive rental of property will not qualify. The decedent must own an equity interest in the farm operation. Additionally, no trade or business is present in the case of activities not engaged in for profit.

Structures and other real property improvements. Qualified real property includes residential buildings and other structures and real property improvements occupied or used on a regular basis by the owner or lessee of real property (or by employees of the owner or lessee) for the purpose of operating the farm or other closely held business. A farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even though a family member (not the decedent) was the person materially participating in the operation of the farm.

Qualified real property also includes roads, buildings and other structures, and improvements functionally related to the qualified use. However, elements of value, such as mineral rights, and hunting rights, that are not related to the farm or business use are not eligible for special use valuation.

Property acquired from decedent. Property is considered to have been acquired from, or to have passed from, the decedent if:

1) The property is so considered under section 1014(b) of the Code (relating to basis of property acquired from a decedent);
2) The property is acquired by any person from the estate in satisfaction of that person's right to a pecuniary bequest; or
3) The property is acquired by any person from a trust in satisfaction of a right (that such person has because of the decedent's death) to receive from the trust a specific dollar amount, which is the equivalent of a pecuniary bequest.

Qualified heir. The term "qualified heir" means, with respect to any property, a member of the decedent's family who acquired such property (or to whom such property passed) from the decedent. If a qualified heir or heiress disposes of any interest in qualified real property to any member of his or her family, such member will thereafter be treated as the qualified heir with respect to such interest.

Member of the family. The term "member of the family" means, with respect to any individual, only such individual's ancestor or lineal descendant, a lineal descendant of a grandparent of such individual, the spouse of such individual, or the spouse of any such descendant. For purposes of the preceding sentence, a legally adopted child of an individual shall be treated as a child of such individual by blood. However, a step child is not a member of the family.

Qualified use is the use of property as a farm for farming purposes or the use in a trade or business other than farming. The mere passive rental of property will not qualify. However, where the decedent's trade or business leases the property and conducts farming or other business activities on the property, the real property may qualify for special use valuation. A net lease to any party other than an entity that is the decedent's trade or business is not a use in a qualified use.

In general, a ***farm*** includes stock, dairy, poultry, fruit, furbearing animals, truck farms, plantations, ranches, nurseries, ranges, and greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities. Farms also include orchards and woodlands.

The term "farming purposes" means:

1) Cultivating the soil or raising or harvesting any agricultural or horticultural commodity, including the raising, shearing, feeding, caring for, training, and management of animals on a farm;
2) Handling, drying, packing, grading or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
3) Planting, cultivating, caring for, or cutting trees, or the preparation (other than milling) of trees for market.

Real property that is used in a ***trade or business*** other than farming may also qualify if the property was used in a trade or business in which the decedent or a member of the decedent's family materially participated prior to the decedent's death. This is true even though the party carrying on the business was not the decedent or a member of the family as long as the decedent or a member of the family personally and materially participated in the operation of the business and the decedent owned an interest in the business.

Community property rules. If the decedent and the decedent's spouse at any time held qualified real property as community property, the special use valuation rules apply as if the property were not community property. Therefore, the community shares of both spouses are combined both for determining if the requisite portions of the decedent's estate consist of qualified property and for purposes of the $500,000 limitation on reduction in value of qualified real property.

Period of material participation. The required participation must last:

1) For periods totaling 5 years or more during the 8 years immediately before the date of the decedent's death; and
2) For periods totaling 5 years or more during any 8-year period ending after the date of the decedent's death (up to a maximum of 15 years after the decedent's death).

In determining whether the material participation requirement is satisfied, no exception is made for periods during which real property is held by the decedent's estate. Additionally, material participation existing at the same time by 2 or more family members during a period totaling a year will not result in that year being counted as 2 or more years for purposes of satisfying the above requirements.

Death of a qualified heir before the required period has passed ends any material participation requirement for that heir's portion of the property as to the original decedent's estate if the heir received a separate, joint, or other undivided property interest from the decedent. If qualified heirs receive successive interests in specially valued property (e.g. life estate and remainder interests) from the decedent, the material participation requirement does not end with respect to any part of the property until the death of the last qualified heir (or, if earlier, the expiration of 15 years from the date of the decedent's death). The requirements will fully apply to an heir's estate if an election is made for the same property by the heir's executor.

In general, to determine whether the required participation has occurred, brief periods (e.g., periods of 30 days or less) during which there was no material participation may be disregarded. This is so only if these periods were both preceded and followed by substantial periods (e.g., periods of more than 120 days) in which there was uninterrupted material participation. See *Required activities*, discussed later in this section, which provides a special rule for periods when little or no activity is necessary to manage fully a farm.

Period property must be owned by decedent and family members. Only real property that is actually owned by any combination of the decedent, members of the decedent's family, and qualified closely held businesses for periods totaling at least 5 of the 8 years preceding the date of decedent's death may be valued under the special-use valuation. For example, replacement property acquired in a

like-kind exchange is considered to be owned only from the date on which the replacement property is actually acquired. On the other hand, replacement property acquired as a result of an involuntary conversion in a transfer that would meet the special-use valuation requirements if it occurred after the date of the decedent's death, is considered to have been owned from the date on which the involuntarily converted property was acquired.

Property transferred from a proprietorship to a corporation or a partnership during the 8-year period ending on the date of the decedent's death is considered to be continuously owned to the extent of the decedent's equity interest in the corporation or partnership if, the transfer meets the requirements of a transfer to a corporation controlled by the transferor (IRC 351), or of the nonrecognition of gain or loss on a contribution to a partnership (IRC 721), and the decedent's interest in the corporation or partnership meets the requirements for indirectly held property. See *Qualified Real Property.*

Likewise, property transferred to a trust is considered to be continuously owned if the beneficial ownership of the trust property is such that the requirements of section 6166(b)(1)(C) would be satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation.

Any periods following the transfer during which the interest in a corporation, partnership, or trust does not meet the requirements may not be counted for purposes of satisfying the ownership requirement.

Required activities for material participation. Actual employment of the decedent (or of a member of the decedent's family) on a substantially full-time basis (35 hours a week or more) or to any lesser extent necessary personally to manage fully the farm or business in which the real property is used constitutes material participation. For example, many farming operations require only seasonal activity. Material participation is present as long as all necessary functions are performed even though little or no actual activity occurs during nonproducing seasons. In the absence of this direct involvement in the farm or other business, the activities of either the decedent or family members must meet the standards prescribed in this paragraph and subject the person to self-employment tax.

If the participant (or participants) is self-employed with respect to the farm or other trade or business, his or her income from the farm or other business must be earned income for purposes of the tax on self-employment income before the participant is considered to be materially participating. Payment of the self-employment tax is not conclusive as to the presence of material participation. If no self-employment taxes have been paid, however, material participation is considered to not have occurred unless the executor demonstrates to the satisfaction of the Internal Revenue Service that material participation did in fact occur and informs the Service of the reason why no tax was paid. In addition, all self-employment taxes (including interest and penalties) determined to be due must be paid.

In determining whether the material participation requirement is satisfied, the activities of each participant are considered separately from the activities of all other participants, and at any given time, the activities of at least one participant must be material. If the involvement is less than full-time, it must be according to an arrangement providing for actual participation in the production or management of production where the land is used by any nonfamily member, or any trust or business entity, in farming or another business. The arrangement may be oral or written, but must be in an arrangement that can be proven. Activities not called for by the arrangement will not support a finding of material participation and activities of any agent or employee other than a family member may not be considered in determining if material participation exists. Activities of family members are considered only if the family relationship existed at the time the activities occurred.

No one factor brings about the existence of material participation, but physical work and participation in management decisions are the principal factors to be considered.

The decedent and/or a family member must regularly advise or consult with the other managing party on the operation of the business. While they need not make all final management decisions alone, the decedent and/or family members must participate in making a substantial number of these decisions.

Also, production activities on the land should be looked at regularly by the family participant, and funds should be advanced and financial responsibility taken on for a substantial portion of the expense involved in the operation of the farm or other business in which the real property is used. In the case of a farm, if the owner or other family members furnish a substantial portion of the machinery, implements, and livestock used in the production activities, it will be an important factor to consider in finding material participation.

If the participating decedent or heir maintains his or her principal place of residence on the premises, it is also a factor to consider in determining whether the overall participation is material if the trade or business is a farm, hotel, or apartment building. Using a professional farm manager will not alone prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must materially participate under the terms of arrangement with the professional farm manager to satisfy this requirement.

Special rules for corporations, partnerships, and trusts. If property is indirectly owned, an arrangement must exist calling for material participation in the business by the decedent owner or a family member. In addition, full-time involvement must be under an arrangment between the entity and the decedent or family member specifying the services to be performed. The holding of an office in which certain material functions are performed may constitute the necessary arrangement for material participation.

If the property is owned by a trust, the arrangement will generally be seen in one or more of the following four situations.

1) The arrangement may result from appointment as a trustee.
2) The arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring material participation in its activities.
3) The participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust.
4) If the trust agreement expressly grants the management rights to the beneficial owner, the grant is sufficient to constitute the required arrangement.

The same participation standards apply where property is owned by a qualified closely held business as where the property is directly owned. In the case of a corporation, a partnership, or trust where the decedent and/or family members are employees and thus not subject to self-employment tax, they are viewed as if they were self-employed and their activities must be of the nature that would subject them to self-employment taxes. Where the property is owned by a corporation, partnership, or a trust, participation in the management and operation of the real property itself as a component of a closely held business is the determinative factor. Nominally holding positions as a corporate officer or director and receiving a salary or merely being listed as a partner and sharing in the profits and losses does not alone support a finding of material participation. This applies even though the partner pays self-employment taxes on the distributive share of partnership earnings. Further, it applies for corporate directors in states where the board of directors need not be an active functioning entity or need only act informally.

However, corporate offices held by an owner are factors considered in judging the degree of participation.

When real property is directly owned and leased to a corporation or partnership in which the decedent owns an interest which qualifies as an interest in a trade or business, the presence of material participation is determined by looking at the activities of the participant with regard to the property in whatever capacity rendered. During any periods when qualified real property is held by an estate, material participation is to be determined as if the property were owned by a trust.

Special-Use Valuation Methods

The special-use valuations for qualified real property that an executor or administrator may elect consist of the following methods.

Method for valuing farm real property. Generally, unless either the executor of the decedent's estate elects otherwise or no cash rental from comparable farm property is documented by the executor, the value of property that is used for farming purposes and eligible for the special valuation is determined as follows.

1) Subtract the average annual state and local real estate taxes on actual tracts of comparable real property from the average gross cash rental for that same comparable property; and
2) Dividing the result so obtained by the average annual effective interest rate charged on new federal land bank loans.

The computation of each average amount is based on the 5 most recent calendar years ending before the date of the decedent's death. The average annual effective interest rates for estates of decedents who died in 1977, 1978, 1979, and 1980 are provided later in this section.

Gross cash rental. Generally, gross cash rental is the total amount of cash received for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued during the period of one calendar year. This amount is not reduced by the amount of any expenses or liabilities associated with the farm operation or the lease. A definition of comparable property and rules for property on which buildings or other improvements are located and on farms including multiple property types is given later in this section. Only rentals from tracts of comparable farm property that are rented solely for an amount of cash, which is not based on production, may be used in valuing real property under this special method. The rentals considered must result from an arms'-length transaction, defined later. Rentals received under leases that provide for payment only in cash are not acceptable as accurate measures of cash rental value if the lessor (or a member of the lessor's family who is other than a lessee) is involved in the management or operation of the farm and such involvement amounts to material participation, explained earlier. The same result occurs whether the lessor's involvement is contemplated or actually occurs. In general, therefore, rentals for any property which qualifies for special-use valuation cannot be used to compute gross cash rentals because the total amount received by the lessor does not reflect the true cash rental value of the real property.

Identification. The executor must identify to the Internal Revenue Service the actual comparable property and cash rentals from that property if the decedent's real property is valued under this special method. If the executor does not identify such property and cash rentals, all specially valued real property must be valued under the rules discussed later for valuing such property in a closely held business if the special-use valuation has been elected. See, however, *Revocation of election,* later in this section for a special rule for estates electing this method of valuation.

Arms'-length transaction. Only those cash rentals which result from a lease entered into in an arms'-length transaction are acceptable under this special method. For these purposes, lands leased from the federal government, or any state or local government, which are leased for less than the amount than would be demanded by a private individual leasing for profit are not leased in an arms'-length transaction. Leases between family members, as defined earlier, which do not provide a return on the property to the same extent as that received under leases between unrelated parties in the locality are not acceptable.

Rents paid in kind and appraisals. Rents that are paid wholly or partly in kind (such as crop shares) may not be used to determine the value of real property under this special method. Likewise, appraisals or other statements regarding rental value as well as area-wide averages of rentals (such as those compiled by the U.S. Department of Agriculture) may not be used under this special method because they are not true measures of the actual cash rental value of comparable property in the same locality as the specially valued property.

Five-year period. Comparable real property rented solely for cash must be identified for each of the 5 calendar years preceding the year of the decedent's death if this special method is used to value the decedent's real property. Rentals from the same tract of comparable property need not be used for each of these 5 years, however, if an actual tract of property meeting the requirements for this method is identified for each year.

Rents that include use of equipment. No adjustment to the rents actually received by the lessor is made for the use of any farm equipment or other personal property when its use is included under a lease for comparable real property unless the lease specifies the amount of the total rental attributable to the personal property.

State and local real estate taxes. For purposes of the farm valuation formula, state and local taxes are taxes that are assessed by a state or local government and that are allowable as itemized deductions. However, only those taxes on the comparable real property from which cash rentals are determined may be used in the formula valuation.

Comparable real property. Comparable real property must be situated in the same locality as the specially valued property. This requirement is not viewed solely in terms of mileage or political divisions, but rather is judged according to generally accepted real property valuation rules. The determination of properties that are comparable is a factual one and must be based on numerous factors, no one of which is determinative. It will, therefore, frequently be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, if the special farm valuation is used, rented property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located. In cases involving multiple uses or land characteristics, actual comparable property for each segment must be used, and the rentals and taxes from all such properties combined for use in the valuation formula. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm also is reflected. All factors generally considered in real estate valuation are considered in determining comparability. While not intended as an exclusive list, the following factors are among those to be considered in determining comparability—

1) Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index;
2) Whether the crops grown are such as would deplete the soil in a similar manner;
3) Types of soil conservation techniques that have been practiced on the two properties;
4) Whether the two properties are subject to flooding;
5) Slope of the land;
6) If livestock operations, the carrying capacity of the land;
7) If the land is timbered, whether the timber is comparable to that on the subject property;
8) Whether the property as a whole is unified or whether it is segmented, and where segmented, the availability of the means necessary for movement among the different sections;
9) Number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se; and
10) Availability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets.

Effective interest rate. Generally, the annual effective interest rate on new federal land bank loans is the average billing rate charged as adjusted on new agricultural loans to farmers and ranchers in the farm credit district in which the real property to be valued is located. This rate is a single rate for each district covering the period of one calendar year and is computed to the nearest one-hundredth of 1%. If the district billing rates of interest on the new agricultural loans change during a year, the rate for that year is weighted to reflect the portion of the year during which the rate was charged. If a district's billing rate on new agricultural loans

varies according to the amount of the loan, the rate applicable to a loan in an amount resulting from dividing the total dollar amount of the loans closed during the year by the total number of the loans closed is to be used. Applicable rates for estates of decedents who died in 1977, 1978, 1979, and 1980 are provided below.

Average annual effective interest rate to be utilized under section 2032 A(e)(7)(A)(ii):

Federal Land Bank District in which property is located	Year of death			
	1977	1978	1979	1980
Baltimore	8.65%	8.86%	9.04%	9.24%
Columbia	8.58%	8.79%	8.96%	9.17%
Houston	8.29%	8.48%	8.60%	8.76%
Louisville	8.64%	8.80%	8.88%	9.21%
New Orleans	8.26%	8.48%	8.72%	8.96%
Omaha	8.70%	8.92%	9.05%	9.25%
Sacramento	8.67%	8.82%	9.04%	9.35%
St. Louis	8.50%	8.71%	8.93%	9.20%
St. Paul	8.21%	8.47%	8.69%	8.95%
Spokane	8.63%	8.88%	9.10%	9.31%
Springfield	8.42%	8.55%	8.65%	8.81%
Wichita	8.52%	8.72%	8.88%	9.08%

The billing rate of interest determined is ***adjusted*** to reflect the increased cost of borrowing resulting from the required purchase of land bank association stock. For special use valuation purposes, the rate of required stock investment is the average of the percentages of the face amount of new agricultural loans to farmers and ranchers required to be invested in the stock by the applicable district bank during the year. If this percentage changes during a year, the average is adjusted to reflect the period when each percentage requirement was effective. The percentage is viewed as a reduction in the loan proceeds actually received from the amount upon which interest is charged.

Example. District X of the federal land bank system charged an 8.5% billed interest rate on new agricultural loans for 8 months of the year, 1979, and 9.05% for 4 months of the year. The average billing rate was, therefore, 8.68% ((1.085 × 8/12) + (1.0905 × 4/12) = 1.0868). The district required stock equal to 5% of the face amount of the loan to be purchased as a precondition to receiving a loan. Thus, the borrower only received 95% of the funds upon which interest was paid. The applicable annual interest rate for 1979 of 9.14% is computed as follows:

8.68% (1.00) = 8.68

8.68% (billed interest rate)/0.95 (% of loan proceeds received by borrower) = 9.14% (effective interest rate for 1979).

Optional method for valuing farms. The method for valuing farm real property (as discussed in the preceding paragraphs) is not used if it is established that there is no comparable land from which the average annual gross cash rental may be determined, or if the executor elects to have the farm valued as a closely held business.

Method of valuing a real property interest in a closely held business. This method is used to determine the special-use valuation for qualifying real property used in a trade or business other than farming and to qualifying farm property if the special farm method for valuation is not used. Under this method, the value of real property is determined by application of the following factors:

1) The capitalization of income that the property can be expected to yield for farming or for closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area taking into account soil capacity, terrain configuration and similar factors;
2) The capitalization of the fair rental value of the land for farming or for closely held business purposes;
3) The assessed land values in a state that provides a differential or use value assessment law for farmland or closely held business;
4) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price; and
5) Any other factor that fairly values the farm or closely held business value of the property.

Dispositions and Failures to Use for Qualified Use

If, within 15 years after the death of the decedent (but before the death of the qualified heir), the property is disposed of by the qualified heir to nonfamily members or ceases to be used for farming or other closely held business purposes, all or a portion of the federal estate tax benefits obtained by virtue of the reduced valuation are to be recaptured.

The amount of the tax benefit potentially subject to recapture is the lesser of:

1) The excess of the estate tax liability that would have been incurred had the special use valuation not been utilized ***over*** the estate tax liability based on the special use valuation; or
2) The excess of the amount realized with respect to the property (or the fair market value of the property in any case other than a sale or exchange at arm's length) ***over*** the value of the property determined under this method of valuation.

If any additional estate tax is due, the qualified heir must file Form 706-A, *United States Additional Estate Tax Return*, within 6 months after the taxable disposition or cessation of the qualified use, unless an extension of time has been granted.

Liability for additional estate tax. A qualified heir is liable personally for the additional estate tax to the extent of the heir's interest in the qualified real property, unless a bond is furnished that meets certain requirements.

Bond requirements. A qualified heir may make a written application to the Internal Revenue Service for a determination of the maximum additional estate tax that may be imposed with respect to the heir's interest in the qualified real property. The Internal Revenue Service will notify the heir of the maximum amount as soon as possible, but not to exceed one year after the application is made, of the maximum amount of the heir's tax liability.

If the qualified heir furnishes a bond for the maximum amount of the tax and for the period required, the heir will be discharged from personal liability. The qualified heir is entitled to a receipt or writing that acknowledges the discharge from personal liability.

Involuntary conversions. If an involuntary conversion—such as a condemnation—of qualified real property takes place and the qualified heir so elects, no additional estate tax will be imposed if the property is replaced by other real property of at least equal value that is used for the same qualified use. Where involuntarily converted property is only partially replaced, the additional estate tax liability is determined by reducing the amount of tax, which would have been imposed, by an amount that bears the same ratio to the tax as the cost of the replacement property bears to the amount realized on the conversion. Any additional estate tax that is imposed on the involuntary conversion is treated as a tax imposed on a partial disposition.

The election is made by notifying the Internal Revenue Service by letter mailed to the IRS office where the decedent's Form 706 was filed. Included in the letter should be a statement of election of such treatment, a description of both the converted property and the replacement property, the amount realized, and the cost of the replacement property.

If the involuntarily converted property is only partially replaced, the election is made on Form 706-A, which is used to compute the additional estate tax liability.

For purposes of determining the imposition of and the amount of the additional estate tax (and the special lien, described later), any qualified replacement property must be treated in the same manner as if it were a portion of the interest in the qualified real property that was involuntarily converted. However, the 15-year period, described earlier, is extended by any period, beyond the 2-year period generally allowed for replacement of involuntarily converted property (under section 1033 of the Code), during which the qualified heir was allowed to replace the qualified real property.

Periods after the involuntary conversion and before the acquisition of the qualified replacement property are not considered in determining whether property has ceased to be used for a qualified use, as described later. Moreover, material participation with respect to the converted property is treated as material participation with respect to the qualified replacement property.

Property ceases to be used for a qualified use if it is no longer used as a farm or in a closely held business, or if no material participation exists for periods of time totaling 3 or more years in any 8-year period ending after the decedent's death (but before the death of the qualified heir). Generally, if the qualified heir dies without having disposed of the property but having retained its qualified use, the potential liability for the additional estate tax ceases.

There is a phaseout of the additional estate tax liability beginning 10 years after the decedent's death. If the disposition or cessation of use occurs in this period, the additional tax imposed is reduced by an amount determined by multiplying the additional tax by a fraction, the numerator of which is the number of full months after the date of death of the decedent in excess of 120, and the denominator of which is 60.

The liability for additional tax is completely eliminated 15 years following the decedent's death.

The additional tax is imposed only once with respect to any interest. The additional tax is due 6 months after the disposition or cessation.

A special lien in favor of the United States in an amount equal to the adjusted tax difference attributable to the interest on the property attaches to the property in which the interest exists. In the case of an involuntary conversion, the lien attaches to the qualified replacment property. The lien continues until:

1) The liability for the additional tax has been satisfied; or
2) The liability has become unenforceable by reason of lapse of time; or
3) It is established to the satisfaction of the Internal Revenue Service that no further tax liability may arise.

Security may be furnished to substitute for this lien. The Secretary of the Treasury may also issue a certificate of subordination of this special lien if it is determined that the interests of the United States are protected adequately after the subordination.

Election of Special Valuation

The election to value qualified real property on the basis of its current use is exercised by attaching to a ***timely*** filed estate tax return an agreement and a notice of election. If the election is not timely made, it is not available to the estate.

The rules for making the election based on proposed regulations may be relied upon up to August 30, 1980. However, all estates which make the elections before the proposed regulations became final will be permitted to revoke their elections. See *Revocation of election*, later in this discussion. Elections made after August 30, 1980, are irrevocable since they are based on the final regulations.

Elections for less than all qualified real property. An election need not include all real property included in an estate that is eligible for special-use valuation. However, at least 25% of the adjusted value of the gross estate must be specially valued under the election. For example, some acreage contained in a farm may be valued at its fair market value if the heirs plan to sell that land while other acres may be valued at their special use value.

If joint or undivided interests (e.g., interests as joint tenants or tenants in common) in the same property are received from a decedent by qualified heirs, an election for one heir's joint or undivided interest need not include any other heir's interest in the same property if the electing heir's interest plus other property to be specially valued satisfy the 25% requirement mentioned above. If successive interests (e.g., life estates and remainder interests) are created by a decedent in otherwise qualified property, the election is available only for that property (or portion thereof) in which qualified heirs of the decedent receive all of the successive interests, and the election must include the interests of all of those heirs. For example, if a surviving spouse receives a life estate in otherwise qualified property and the spouse's brother receives a remainder interest in fee, no part of the property may be valued according to the special value election.

Where successive interests in specially valued property are created, remainder interests are treated as being received by qualified heirs only if a qualified heir receives a present interest in that real property, all preceding interests in the property are vested absolutely in the qualified heirs, and the remainder interests are not contingent upon surviving an alternate taker who is not a member of the decedent's family or are not vested subject to divestment in favor of a nonfamily member.

Agreement to special-use valuation. Generally, the agreement must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. In the case of a qualified heir, the agreement must express consent to personal liability for additional estate tax in the event of certain early dispositions of the property or early cessation of the qualified use. In the case of parties (other than qualified heirs) with interests in the property, the agreement must express consent to collection of any additional estate tax imposed.

The agreement is to be in a form that is binding on all parties having an interest in the property. It must designate an agent with satisfactory evidence of authority to act for the parties to the agreement in all dealings with the Internal Revenue Service on matters arising under the agreement to the special valuation and must indicate the address of that agent.

The Internal Revenue Service will contact the agent designated in the agreement on all matters relating to continued qualification of the specially valued real property and on all matters relating to the special lien. It is the duty of the agent as attorney-in-fact for the parties with interests in the specially valued real property to furnish the Service with any requested information and to notify the Service of any disposition or cessation of qualified use of any part of the property.

An ***interest in property*** is an interest that, as of the date of the decedent's death, can be asserted under local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any interest in the property, whether present or future, or vested or contingent, must enter into the agreement. Included among those persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any power, co-tenants, joint tenants, and holders of other undivided interests when the decedent held a joint or undivided interest in the property, and trustees of trusts holding any power, and trustees of trusts holding any interest in the property.

An heir who has the power under local law to challenge (caveat) a will and thus, affect disposition of the property is not, however, considered a person with an interest in property. Likewise, an estate's creditors are not interested persons solely by reason of their status as creditors.

If any interested party desires that an agent act for him/her or cannot legally enter a binding agreement due to infancy or incompetence, or due to death before the election is timely exercised, a representative authorized under local law to bind that person in an agreement of this nature is permitted to sign the agreement on the interested party's behalf.

Notice of election. The notice must contain the following information:

1) Decedent's name and taxpayer identification number as they appear on the estate tax return;
2) Relevant qualified use;
3) Items of real property shown on the estate tax return to be specially valued under the election (identified by schedule and item number);
4) Fair market value of the property to be specially valued and its value based on its qualified use (both values determined without reduction for unpaid mortgages, etc.);
5) Adjusted value of all real property (after reduction for unpaid mortgages, etc.), which is used in a qualified use and which passes to the decedent's heirs and the adjusted value of all real property to be specially valued;
6) Items of personal property shown on the estate tax return that pass from a decedent to a qualified heir and are used in a qualified use (identified by schedule and item number) and the total value of the personal property (reduced by unpaid morgages, etc.);

7) Adjusted value of the gross estate (gross estate less any amounts allowable as a deduction under section 2053(a)(4), such as the unpaid mortgages);

8) Method used for determining the special value based on use;

9) Copies of written appraisals of the fair market value of the real property;

10) A statement that the decedent and/or a member of his or her family has owned all specially valued real property for at least 5 years immediately preceding the date of the decedent's death;

11) Any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his/her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business;

12) Name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each person based on both fair market value and qualified use;

13) Affidavits describing the activities constituting material participation and the identity of the material participant or participants; and

14) A legal description of the specially valued property.

If neither an election nor a protective election is timely made, special-use valuation is not available to the estate.

Protective election. A protective election may be made to specially value qualified real property. The availability of special use valuation under this election is contingent upon values as finally determined (or agreed to following examination of a return) that meet the requirements of the special-use election. A protective election does not extend the time for payment of any tax.

The protective election is made by filing a notice of election with a timely estate tax return stating that a protective election for special use valuation is being made pending final determination of values. The notice must include the following information:

1) Decedent's name and taxpayer identification number as they appear on the estate tax return;

2) Relevant qualified use; and

3) Items of real and personal property shown on the estate tax return that are used in a qualified use, and that pass to qualified heirs (identified by schedule and item number).

If it is found that the estate qualifies for special-use valuation based upon values as finally determined (or agreed to following examination of a return), an additional notice of election must be filed within 60 days after the date of the determination. This notice must contain the information required for an actual election and must be attached together with an agreement to an amended estate tax return. The amended return is to be filed with the Service office where the original return was filed.

Revocation of election. All estates that made elections on or before August 30, 1980, may revoke their elections. To revoke an election, an executor must file a notice of revocation with the Internal Revenue Service Center where the original estate tax return was filed. This notice of revocation must be filed on or before January 31, 1981, (or if earlier, the date on which the period of limitations expires). The notice of revocation must contain the decedent's name, date of death, and taxpayer identification number. It must also include the remittance of any additional amount of estate tax and interest determined to be due as a result of valuation of the qualified property on the basis of its full fair market value.

Elections that were made on or before August 30, 1980, that were not conformed to the proposed regulations, must be conformed to the final regulations before the original estate tax return can be finally excepted by the Internal Revenue Service.

9. The Taxable Estate

The taxable estate is the gross estate less:

1) Administration and funeral expenses;

2) Claims against the estate;

3) Any outstanding obligation to which the property is subject if the value is included in the gross estate and is undiminished by the outstanding indebtedness;

4) Casualty and theft losses;

5) Orphans' deduction;

6) Marital deduction; and

7) Charitable deduction.

A) Administration Expenses, Funeral Expenses, Claims, and Obligations

A deduction is allowed for amounts payable out of ***property subject to claims*** (generally, the probate assets) for:

1) Funeral expenses;

2) Administration expenses incurred in administering property subject to claims;

3) Claims against the estate; and

4) Unpaid mortgages and other charges against property including the interest accrued to the date of decedent's death, if the value of the property is included in the gross estate without reduction for the mortgage or other indebtedness.

If the estate is liable for the payment of the obligation, the full value of the property must be included in the gross estate and the amount of the outstanding indebtedness must be deducted.

If the estate is not liable for the obligation, only the value of the property less the obligation has to be included on the return.

However, if the decedent gave real property within 3 years of death, and the donee mortgaged the property, the value of the property is included in the decedent's gross estate undiminished by the amount of the mortgage because the mortgage did not benefit the decedent.

Limitation. The amount of the deduction is the amount paid for these expenses allowable under the local law governing the administration of the decedent's estate. The total deduction, however, is limited to:

1) The value of property subject to claims included in the decedent's gross estate; ***plus***

2) The amount paid out of property included in the gross estate but not subject to claims, if actually paid within the time allowed for the filing of the estate tax return.

The applicable state law determines which property is subject to claims and which property is not subject to claims. If under state law, a particular property interest included in the decedent's gross estate would bear the burden for the payment of the expenses, then the property is considered ***property subject to claims.***

Example. The only items in the gross estate were a bank deposit of $20,000 and jointly owned real estate, valued at $250,000 at decedent's death. The bank account was subject to claims, but the real estate, under local law, was not subject to claims. Funeral expenses amounted to $1,000 and the debts of the decedent totaled $29,000; both were allowable under local law.

If the executor paid the funeral expenses and $19,000 of the debts out of the bank account, the estate could claim $20,000 in deductions.

If, in addition, the surviving spouse paid the remaining $10,000 of debts ***before*** the executor filed the return, the estate could claim a $30,000 deduction.

If the surviving spouse paid the remaining $10,000 in debts ***after*** the time required to file the return, the estate could claim only $20,000 in deductions.

If, on the other hand, the executor paid only $5,000 out of the bank account for the funeral expenses and debts, and the surviving spouse paid $20,000 ***before*** filing the return and the remaining $5,000 ***after*** the time required to file, the estate would be entitled to the full $30,000 deduction. This is because the allowable deduction is the amount that is ***payable*** out of property subject to claims and is actually paid ($30,000) from any source in the gross estate, but limited to the value of:

1) The property subject to claims ($20,000); ***plus***

2) The amount actually paid out of property not subject to claims before the return is filed ($20,000).

Since the amount actually paid ($30,000) is within the limitation ($40,000), the full $30,000 may be deducted.

Property not subject to claims. A deduction also is allowed for the expense of administering property that is not subject to claims (generally, nonprobate assets included in the gross estate), if:

1) The expense is paid before the expiration of the period of limitation for assessing the Federal estate tax (generally, 3 years after filing); and
2) The expense is allowable by the law governing the administration of the decedent's estate as if the property were subject to claims.

Administration expenses. These expenses include the commissions of the executor or administrator, fees of attorneys for the estate, and miscellaneous costs such as accountants' fees, court costs, selling expenses for selling estate property if these sales are necessary to settle the estate, and excise taxes incurred in these sales.

Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees are not deductible. An attorney's fee incurred by a beneficiary that is not essential to the proper settlement of the estate is not deductible as an administrative expense, even if it is approved by a probate court as an expense payable or reimbursable by the estate.

Interest expense on income tax. Post-death interest on federal and state income tax deficiencies while an executor of a decedent's estate contests the imposition of the taxes is deductible as an administration expense if allowable under local law.

Interest expense on estate tax. Interest payable on a loan incurred to pay estate taxes is deductible as an administration expense. However, the expense must be allowable under local law.

Interest incurred as the result of a federal estate tax deficiency is a deductible administration expense to the extent the expense is allowable under local law.

Also, an administration expense is allowed for interest payable by an executor electing to pay the estate tax in installments for certain estates consisting largely of an interest in a closely held business if the expense is allowable under local law.

Interest accrued on obligation of decedent. An administration expense is not allowed for interest payable after a decedent's death attributable to an installment obligation incurred by the decedent. If the decedent had lived, the decedent would have been liable for the interest as well as the principal. Since the interest is not actually and necessarily incurred in the administration of the decedent's estate, it is not allowable as an administration expense.

Claims against the estate. These include property taxes accrued before the decedent's death, unpaid income taxes on income received by the decedent during life, and unpaid gift taxes on gifts made by the decedent during life. State inheritance taxes and federal estate taxes are not deductible.

Any income taxes on income received after the decedent's death, or property taxes not enforceable before death, or any state, succession, legacy, or inheritance taxes are not deductible.

Amounts that may be deducted as claims against a decedent's estate are only for enforceable personal obligations of the decedent at the time of death whether or not then matured and interest thereon which had accrued at the time of death. Only interest accrued at the date of the death of the decedent is deductible even though the executor elects the alternate valuation date. Deductions for claims founded upon promises or agreements are limited to the extent that the liabilities were contracted in good faith and for adequate and full consideration in money or money's worth. However, a pledge or subscription in favor of a public, charitable, religious, or educational organization is deductible to the extent that it would have constituted an allowable deduction had it been a bequest. (See *E) Charitable Deduction,* later.)

Deductibility of funeral and last illness expenses. The estate is allowed a deduction for funeral expenses, and expenses of the last illness of a wife in those jurisdictions where the estate is primarily liable for the expenses. This rule may be illustrated in the following example.

Example. The statutory and decisional law of the jurisdiction where the wife's estate was administered provides that in all cases the decedent's estate is primarily liable for funeral expenses, while a surviving spouse of an indigent decedent is under a secondary duty to defray such expenses. The local courts allow the funeral expenses and the expenses of the last illness as claims against the estate as long as the estate is solvent.

In this situation the estate is primarily liable for the expenses and a deduction is allowable against the gross estate for expenses paid and allowable by the local courts as claims against the estate.

Expense uncertain. If at the time of filing the estate tax return, the exact amount of a deductible item is not known, an estimated amount for that item may nevertheless be entered on the return if the estimated amount can be determined with reasonable certainty and it can be shown that the item will be paid.

Income tax vs. estate tax deduction. Amounts allowable as deductions for administration expenses or losses during administration of the estate may not be used as deductions in computing the taxable income of the estate for income tax purposes unless the deduction for estate tax purposes is waived. It is not required that the total deductions, or the total amount of any deduction be treated in the same way. One deduction, or a portion of a deduction, may be allowed for income tax purposes if the waiver is filed while another deduction or portion is allowed for estate tax purposes.

The waiver should be filed with the income tax return in the year the expenses are claimed on the return for income tax purposes. This waiver is irrevocable. Medical, dental, etc. expenses of a decedent, which are paid by the estate and are deductible administration expenses, cannot be taken as a deduction in computing the taxable income of the estate.

However, taxes, interest, and business expenses accrued at the date of the decedent's death attributable to ***income in respect of a decedent*** are deductible on the decedent's income tax return and are also deductible as administration expenses on the estate tax return. See Publication 559, *Tax Information for Survivors, Executors, and Administrators,* for a discussion of income in respect of a decedent. Funeral expenses are allowable only as deductions in computing the estate tax.

Medical expenses. Medical expenses, if deducted only on the estate tax return, are fully deductible as administration expenses.

Expenses for the medical care of the taxpayer, if paid within the one-year period after date of death, may be deducted on the decedent's income tax return only to the extent that they exceed 3% of the decedent's adjusted gross income.

However, if part of the medical expenses are deducted on the decedent's final income tax return and part deducted on the estate tax return, the part deducted on the estate tax return may not include the amount equal to 3% of the decedent's adjusted gross income that is not deductible for income tax purposes.

Example. The decedent incurred $20,000 in medical expenses during the 6-month period prior to death. The decedent's final income tax return showed an adjusted gross income of $100,000.

The decedent's personal representative paid the $20,000 in medical expenses within one year of the decedent's death. The personal representative elected to deduct $5,000 as a claim against the estate and filed the necessary statement that $15,000 had not and would not be deducted for estate tax purposes. Therefore, only $12,000 ($15,000 − (3% × $100,000)) is deductible on the decedent's final income tax return.

If the personal representative had elected to deduct all the medical expenses as claims against the estate, $20,000 would be deductible for estate tax purposes.

Selling expenses. Amounts cannot be used to offset the amount of the sales price of property if that amount has been deducted for estate tax purposes as an administration expense.

Alimony payments. The commuted value of alimony payments to be made under a di-

vorce decree, issued by a court having the power to settle all property rights, providing that the husband-decedent or his estate would make payments to the wife until her death or remarriage is a claim against the deceased husband's estate and deductible for estate tax purposes. The alimony payments made by the fiduciary during administration are deductible for income tax purposes. If the court did not have jurisdiction to settle all property rights, the value of the alimony payments would be deductible only to the extent that they do not exceed the reasonable value of the wife's support rights.

State or foreign death tax deduction. If a state or a foreign country imposes a death tax on a transfer for charitable purposes, by a decedent, a deduction may be taken for the payment of this tax, if elected, rather than the state or foreign death tax credit. The deduction is allowed only if the benefit of the deduction inures solely to the charity. When the deduction is claimed, the credit for state death taxes or foreign death taxes, whichever is applicable, is reduced to reflect that a portion of the tax is used as a deduction rather than as a credit.

Insurance proceeds paid to divorced spouse. Generally, life insurance proceeds paid directly to a divorced spouse are includible in the estate of a decedent who, under the divorce decree, was required to name the spouse as beneficiary of a life insurance policy and who was obligated to keep the policies in force until her death or remarriage. (See discussion under Section 7(l), *Proceeds of Life Insurance.)*

The payment of the insurance proceeds to the former spouse represents the satisfaction of an indebtedness created in settlement of the decedent's marital obligations.

Thus, since the insurance proceeds are includible in the decedent's gross estate at full value (because of a reversionary interest in the proceeds), the obligation to pay the decedent's former spouse is an indebtedness against property included in the gross estate. Therefore, the proceeds of the life insurance policy may be deducted from the gross estate of the decedent.

Where deducted. Funeral expenses and expenses incurred in administering property subject to claims are listed on Schedule J, Form 706.

B) Casualty or Theft Losses

Deductions are allowed for losses incurred during the settlement of the estate arising from theft or casualties, such as storms or fires, but only to the extent that these losses are not compensated for by insurance or in another manner. No deduction is allowed from the gross estate for losses claimed for income tax purposes.

The net losses allowable for estate tax purposes are listed on Schedule L, Form 706.

C) Orphans' Deduction

A deduction is allowed for transfers to a decedent's minor children who have no known surviving parent.

A minor child is one who is less than 21 years old at the date of the decedent's death.

If a child's parents were divorced, when the deceased parent is survived by the other known parent, the orphans' deduction will not be allowed. On the other hand, a relationship by legal adoption supplants the relationship by blood. Thus, the orphans' deduction is allowable to the estate of a deceased adoptive parent who is not survived by a spouse even though one or both of the natural parents of the child are known and surviving. However, an adoption will not supplant the relationship by blood where it can be shown that the adoption was motivated to obtain this deduction.

Limitation. The deduction for an interest passing to a minor child may not exceed $5,000 multiplied by the number of years by which 21 exceeds the child's age as of decedent's death.

Example. If the child is age 15, the deduction cannot exceed $30,000 [$5,000 × 6 (21 minus 15)].

Limitation if life estate or other terminable interest. The deduction is allowed for property passing to the minor child only to the extent that a marital deduction would have been allowable if the same property had passed to the decedent's surviving spouse, with one exception. If the interest of the child is terminable only because the interest will pass to another person if the child having the interest dies before the youngest child of the decedent attains age 23, the orphans' deduction may still be taken.

Qualified minors' trust. The interest of a minor child in a qualified minors' trust is treated as an interest in property that passes or has passed from the decedent to a minor child.

A qualified minors' trust is a trust that meets the following requirements:

1) All of the beneficiaries of the trust are the decedent's minor children, except as provided in (4);
2) The corpus of the trust is property that passes or has passed from the decedent to the trust;
3) All distributions from the trust to its beneficiaries before termination of their interests will be pro rata, except as discussed later under *Certain disproportionate distributions;*
4) On the death of any beneficiary and before the termination of the trust, the beneficiary's pro rata share of the corpus and accumulated income either:
   a) Remains in the trust for the benefit of the decedent's minor children who survive the beneficiary, or
   b) Vests in any person; and
5) On the termination of the trust, each beneficiary will receive a pro rata share of the corpus and accumulated income.

Certain disproportionate distributions. A trust will not fail to meet the pro rata distribution requirements in (3) solely because the governing instrument of the trust permits disproportionate distributions to beneficiaries that are limited by an ascertainable standard relating to their health, education, support, or maintenance.

Accumulation of trust income. A trust is not disqualified solely because the trustee has the power to accumulate income.

Death of beneficiary. A minor child's interest in a trust is not disqualified solely because that interest will pass to another if the child dies before the decedent's youngest child reaches age 23.

Deduction reduced by federal estate tax. If the value of property passing to certain minor children is burdened with the payment of any death taxes, the orphans' deduction is reduced by the amount used to pay the taxes. The payment of death taxes from a deductible interest causes a situation known as an ***interrelated computation*** of the federal estate tax. This computation is explained in Publication 904, *Computing the Interrelated Charitable, Marital, and Orphans' Deductions, and Net Gifts,* which may be obtained from your local Internal Revenue Service Office.

Where deducted. The orphans' deduction is computed on Schedule N, Form 706.

D) Marital Deduction

The estate tax marital deduction is a deduction from the gross estate of the value of property that is included in the gross estate but that passes, or has passed, to the surviving spouse.

Property interests passing to the surviving spouse include any interest taken:

1) As decedent's legatee, devisee, heir, or donee;
2) As decedent's surviving tenant by the entirety or joint tenant;
3) As appointee under decedent's exercise of a power or as taker in default upon decedent's nonexercise of a power;
4) As beneficiary of insurance upon the decedent's life.

Interests passing to the surviving spouse include dower (or curtesy) interests or the statutory estate in place of dower or curtesy, if elected. They also include an interest under community property laws to the extent that such interest was, immediately prior to the decedent's death, a mere expectancy in the surviving spouse.

In order for property passing from a decedent to a surviving spouse to qualify for the marital deduction, the spouse must survive the decedent and the decedent must be married to the transferee at the time of death. The marital deduction is not allowable with respect to transferred property if the decedent

was not married to the transferee at the time of death even though the transferee was the decedent's spouse at the time of the transfer.

The parties are considered to have been married at the time of the decedent's death in spite of a prior ex parte divorce, if the divorce had been overturned by a court having personal jurisdiction over the spouses.

A property interest disclaimed by the surviving spouse is considered as passing to the person entitled to receive that interest as a result of the disclaimer. If the surviving spouse receives an interest in property as a result of a qualified disclaimer by another person, that interest is considered as passing directly from the decedent to the surviving spouse.

Such an interest may qualify for the marital deduction if it was disclaimed before the other person accepts any property under the disclaimed interest, and before the due date for filing the estate tax return. If either of these conditions has not been met, the disclaimed interest is considered as passing, not to the surviving spouse, but to the person making the disclaimer as though the disclaimer had not been made.

Federal estate taxes or other death taxes that are paid out of the surviving spouse's share of the gross estate are not included in the value of property interests passing to the surviving spouse.

If a property interest passes to a surviving spouse, subject to a mortgage or other encumbrance, or if an obligation is imposed upon the surviving spouse in connection with the passing of a property interest, only the net value of the interest after reduction by the amount of the mortgage or other encumbrance qualifies for the marital deduction.

A property interest passes to a surviving spouse when an executor is required, under the terms of a will, to satisfy a debt of the surviving spouse for which the decedent had no liability. The amount of the bequest to satisfy the debt qualifies for the marital deduction.

Whenever a surviving spouse receives a bequest with a condition that the surviving spouse relinquish certain other property, the value of the conditional bequest is the amount by which it exceeds the value of the relinquished property. However, if the executor is required, under the terms of the decedent's will or under local law, to discharge the mortgage or other encumbrance out of other assets of the estate, or to reimburse the surviving spouse, the payment or reimbursement constitutes an additional interest passing to the surviving spouse.

Terminable Interests

Certain interests in property passing from a decedent to a surviving spouse are referred to as ***terminable interests***. Such an interest is one that will terminate or fail after the passage of time, or upon the occurrence or nonoccurrence of some contingency. Examples are: life estates, annuities, estates for terms of years, and patents.

A terminable interest will not qualify for the marital deduction if:

1) Another interest in the same property passed from the decedent to some other person for less than adequate and full consideration in money or money's worth; and
2) By reason of its passing, such other person or that person's heirs may enjoy part of the property after the termination of the surviving spouse's interest.

Example 1. A decedent devised real property to his wife for life, with remainder to his children. The life interest that passed to the wife does not qualify for the marital deduction since it will terminate at her death and the children will thereafter possess or enjoy the property. However, the value of a widow's dower, if requested and paid in accordance with the applicable State law, is a nonterminable interest that qualifies for the marital deduction.

Example 2. Matthew Smith purchased a joint and survivor annuity for himself and his wife, who survived him. The value of the survivor's annuity, to the extent that it is included in the gross estate, qualifies for the marital deduction because even though the interest will terminate on the wife's death, no one else will possess or enjoy any part of the property.

Exceptions. There are, however, three exceptions to the terminable interest rule. A property interest passing from the decedent to the surviving spouse is not treated as a nondeductible terminable interest if:

1) It is a right to income for life with a power of appointment meeting the requirements discussed later;
2) It consists of life insurance or annuity payments held by the insurer with a power of appointment in the spouse, meeting the requirements discussed later; or
3) It is conditioned on the spouse's surviving for a limited period, in the manner described later.

Income interest with power of appointment. A property interest passing from the decedent to a surviving spouse is considered a deductible interest if it satisfies the following five conditions:

1) The surviving spouse is entitled to all (or a specific part of all) of the income from the entire interest (or a specific part thereof) for life;
2) Such income is payable annually or at more frequent intervals;
3) The surviving spouse has the power of appointment, exercisable in favor of the surviving spouse or of the estate of the surviving spouse to appoint the entire interest;
4) Such power is exercisable by the surviving spouse alone and in all events (although it may be limited to exercise either during life or by will); and
5) No part of the interest is subject to a power in any other person to appoint to anyone other than the surviving spouse.

If either the right to income or the power of appointment passing to the surviving spouse pertains only to a specific portion of a property interest passing from the decedent, the marital deduction is allowed only to the extent that the rights in the surviving spouse meet all of these five conditions. In determining whether a surviving spouse is entitled to receive all the income from a specific portion of an interest, it is not necessary that the surviving spouse receive a fractional or percentile share of all the income from the entire interest. When a surviving spouse is entitled to receive a specified sum of income per year, the capital amount that would produce such a specified sum will be considered the specific portion from which the surviving spouse is entitled to receive the income.

Life insurance with power of appointment. A property interest consisting of the entire proceeds of a life insurance, endowment, or annuity contract passing from the decedent to the surviving spouse is considered a deductible interest if:

1) The surviving spouse is entitled to receive such proceeds in installments, or is entitled to interest thereon, with all amounts payable during the surviving spouse's life and only to the surviving spouse;
2) The installment or interest payments are payable annually, or more frequently, beginning not later than 13 months after the decedent's death;
3) The surviving spouse has the power, exercisable in favor of the surviving spouse or of the estate of the surviving spouse, to appoint all amounts payable under the contract;
4) The power is exercisable by the surviving spouse alone and in all events (although it may be limited to exercise either during life or by will); and
5) No part of the amount payable under the contract is subject to a power in any other person to appoint to anyone other than the surviving spouse.

If the foregoing five conditions are met only for a specific portion of the proceeds, the rules already set forth for a partial interest in property are applicable in determining the extent of the allowable deduction.

Survival for limited period requirement. If a property interest passed from a decedent to a surviving spouse, subject to a provision that it was to pass to some other person if the spouse should fail to survive the decedent by 6 months (or by a shorter period), or if the decedent and the spouse should die as a result of a common disaster, the property interest is deductible if the spouse survived beyond the stated period or if the decedent and the spouse did not die as the result of a common disaster.

Limitation on Marital Deduction

The maximum estate tax marital deduction for property passing from a decedent to the surviving spouse is the ***greater*** of:

1) $250,000; or

2) 50% of the value of the decedent's adjusted gross estate.

The deduction is limited to the actual value of the interest that passes, or has passed, from the decedent to the surviving spouse.

The ***adjusted gross estate*** is the gross estate less the following deductions:

1) Administration and funeral expenses;
2) Claims against the estate;
3) Any outstanding obligation to which property is subject, if the value of the property is included in the value of the gross estate and is undiminished by the outstanding indebtedness; and
4) Casualty and theft losses.

The gross estate is increased by any generation-skipping transfer occurring at the same time as, or within 9 months after, the death of a deemed transferor. For a further discussion, see Section 10(B), *Deemed Transferor's Marital Deduction*, in Part III.

Reduction for gifts to spouse. The allowable estate tax marital deduction is reduced by the amount by which the gift tax marital deduction allowed exceeds 50% of the value of the property that was transferred to the spouse after 1976, for which a gift tax return was required to be filed. Gifts to a spouse included in the gross estate as ***transactions within 3 years of death*** are not taken into account for purposes of computing the amount of the reduction. The gift tax marital deduction and its effect on the estate tax marital deduction is discussed in Section 14(C), *Gifts to Spouse (Marital Deduction)*, of Part II.

Community property adjustment. In order to equalize the treatment for community property, both the $250,000 amount and the adjusted gross estate may have to be reduced before computing the limitation on the marital deduction.

Computation of adjusted gross estate. The entire value of the gross estate must be reduced by the following to arrive at the adjusted gross estate.

1) The value of the community property held by the decedent at death; and
2) The value of the community property transferred by the decedent during life; and
3) The insurance proceeds of policies on the life of the decedent to the extent purchased with community funds; and
4) An amount that bears the same ratio to the ***total allowable deductions*** for expenses, indebtedness, taxes, and losses that the value of the total gross estate reduced by (1), (2), and (3) (the decedent's community property interest) bears to the value of the entire gross estate.

The amount of the ***total allowable deductions*** under (4) is ***all*** the allowable deductions whether or not they are attributable to community property interests or noncommunity property interests.

Reduction of the $250,000 limitation. The $250,000 amount must be reduced by the excess of:

A) The subtractions from the gross estate just listed in items (1), (2), and (3);

minus

B) The excess of the total allowable deductions for expenses, indebtedness, taxes, and losses ***over*** the result just figured in (4).

The reduction of the limitation on the marital deduction is illustrated in the following example.

Example. The total value of John Hawthorne's estate is $300,000, of which $200,000 is his separate property that he inherited from his father, and $100,000 represents his one-half interest in community property. The total debts and expenses are $45,000. The entire estate passes to the surviving spouse. The adjusted gross estate and the limitation on the marital deduction is computed as follows:

Value of the total gross estate		$300,000
Reduction under (1)		
Value of community property held at death	$100,000	
Reduction under (4)		
$\frac{\$200,000}{\$300,000} \times \$45,000$	30,000	
Total reduction		130,000
Adjusted gross estate		$170,000
One-half of the adjusted gross estate		$ 85,000

The dollar limitation on the marital deduction is computed as follows:

Dollar limitation		$250,000
Reduction:		
Community property	$100,000	
Less: Total debts and expenses $45,000		
Less: Reduction under (4) 30,000		
	15,000	
Reduction		85,000
Reduced dollar limitation		$165,000

The limitation on the marital deduction is $165,000.

The preceding example illustrated the computation of the marital deduction when the decedent's gross estate included separate property that had not been converted from community property.

Converted property. If the deceased spouse's gross estate includes separate property that is, or is traceable to, separate property that had been converted from community property after 1941, by one transaction or a series of transactions, that separate property is considered community property for purposes of computing the marital deduction.

If the value of the separate property acquired by the decedent as a result of a conversion did not exceed the value of the separate property thus acquired by the surviving spouse, the entire separate property acquired by the decedent is to be considered as held by the decedent and the surviving spouse as community property. If the value (at the time of the conversion) of the separate property so acquired by the decedent exceeded the value (at that time) of the separate property so acquired by the spouse, only a part of the separate property so acquired by the decedent (and only the same fractional part of property acquired by the decedent in exchange for such separate property) is to be considered as held by him and his surviving spouse as community property. The part of such separate property (or property acquired in exchange therefor) which is considered as so held is the same proportion of it which the value (at the time of the conversion) of the separate property so acquired by the spouse is of the value (at that time) of the separate property so acquired by the decedent.

Conversions within the scope of this provision include:

1) A partition of community property between husband and wife, in which a portion of the property became the separate property of each;
2) A transfer of community property into some other form of co-ownership, such as a joint tenancy;
3) An agreement (whether made before or after marriage) that future earnings and gains that would otherwise be community property shall be shared by the spouses as separate property; and
4) A change in the form of ownership of property that causes the future rentals, which would otherwise have been acquired as community property, to be acquired as separate property.

Note. Generally, assets derived from converted community property retain the same character as the underlying property. However, assets acquired with income derived from separate property by a decedent while residing in a common law state, to which the decedent was entitled under local law, is considered as the decedent's separate property for purposes of computing the marital deduction even though the separate property that produced the income was purchased with converted community property.

The burden of establishing the extent to which separate property of the decedent was acquired other than by a conversion rests upon the executor.

The surviving spouse's community property interest is not eligible for the marital deduction because the surviving spouse's community interest is not included in the decedent's gross estate.

Example. While alive, Mr. Hawthorne and his wife partitioned some community property valued at $224,000. As a result of this conversion, Mr. Hawthorne received separate property valued at $160,000 and his wife received separate property valued at $64,000.

When Mr. Hawthorne died, the value of his gross estate was $300,000. His separate property, which consisted solely of the partitioned community property, was valued at $200,000. The remaining $100,000 represented his interest in the community property. The deductions of the estate for expenses, taxes, and losses total $45,000.

The adjusted gross estate is computed as follows:

Gross estate		$300,000
Less:		
1) Value of community property held at death	$100,000	
2) Proportionate share of community property converted to separate property (considered community property) $\frac{\$\ 64,000}{\$160,000} \times \$200,000$	80,000	
Total reduction		$180,000
		$120,000
3) Reduction for expenses, taxes, and losses $\frac{\$120,000}{\$300,000} \times \$45,000$		18,000
Adjusted gross estate		$102,000

Deduction Reduced by Death Taxes

If the value of property passing to a surviving spouse is burdened with the payment of any death taxes, the marital deduction is reduced by the amount used to pay the taxes. The marital deduction is likewise reduced if the executor has the discretionary power to pay any death taxes from the marital interest, regardless of whether the executor uses that discretion. The marital deduction is limited to the value of property that could not have been allocated for the payment of death taxes. The payment of death taxes from a deductible interest causes a situation known as an ***interrelated computation*** of the federal estate tax. This computation is explained in Publication 904, *Computing the Interrelated Charitable, Marital, and Orphans' Deductions, and Net Gifts*, which may be obtained from the Internal Revenue Service.

Generation-Skipping Transfers

If a generation-skipping transfer occurs at the same time as, or within 9 months after, the deemed transferor's death, the gross estate of the deemed transferor is deemed increased by the amount transferred for the purpose of computing the marital deduction. Generation-skipping transfers are discussed in Part III.

Where to compute marital deduction. In general, property interests included in the gross estate that pass from the decedent to the surviving spouse and as to which a marital deduction is authorized should be listed on Schedule M, Form 706. The marital deduction is computed on page 3, *Recapitulation*, of Form 706. See the instructions to the form for additional information.

E) Charitable Deduction

A deduction is allowed for the value of property in the decedent's gross estate that was transferred by the decedent during life or by will to (or for the use of):

1) The United States, any state, any political subdivisions thereof, or the District of Columbia, for exclusively public purposes;
2) Any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment) and the prevention of cruelty to children or animals, as long as no part of the net earnings inures to the benefit of any private individual and no substantial activity is undertaken to carry on propaganda, or otherwise attempt to influence legislation or participate in any political campaign on behalf of any candidate for public office;
3) A trustee or trustees, or a fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, and no substantial activity is undertaken to carry on propaganda or otherwise attempt to influence legislation, or participate in any political campaign on behalf of any candidate for public office;
4) Any veterans' organization incorporated by an Act of Congress or any of its departments or local chapters or posts, for which no part of the net earnings inures to the benefit of any private individual; or
5) A foreign government or its political subdivision when the use of such property is limited exclusively to charitable purposes.

Transfers subject to a condition or power. If, at the date of the donor-decedent's death, a transfer to a qualified charity is contingent upon some act or occurrence, no deduction is allowable unless the possibility that the transfer will not become effective is so remote that the contingency is negligible.

If the donee or the trustee has the power to divert the property or fund, in whole or in part, for a use or purpose that is not deductible, only the portion of the property or fund not subject to this power is deductible.

Disclaimers. The charitable deduction is allowed for amounts that are transferred to charitable organizations as a result of either a qualified disclaimer or the complete termination of a power to consume, invade, or appropriate property for the benefit of an individual, whether termination occurs by reason of the death of the individual or otherwise. The termination must occur within the period required for a qualified disclaimer and before the power has been exercised.

Qualified disclaimers are discussed in Section 10(B), *Qualified Disclaimers*, of Part II.

Payments in compromise. If a charitable organization assigns or surrenders a part of a transfer to it pursuant to a compromise agreement to settle a controversy, the amount surrendered or compromised is not deductible as a transfer to that charitable organization.

Payment of death taxes. The deduction is limited to the amount actually available for charitable uses. Thus, if under the terms of a will or the provisions of local law, or for any other reason, the federal estate tax, or any other death tax, is payable in whole or in part out of property, the transfer of which would otherwise be allowable as a charitable deduction, the deductible sum is the amount of the transferred property reduced by such taxes. However, the charitable deduction allowable for the residue of an estate is not reduced by the amount of state inheritance taxes that would be imposed upon the exercise of a power of appointment over trust property, if the donee of the power dies before the due date for filing the decedent's estate tax return, without having exercised the power.

The payment of death taxes from a deductible interest causes a situation known as an ***interrelated computation*** of the federal estate tax. This computation is explained in Publication 904, *Computing the Interrelated Charitable, Marital, and Orphans' Deductions, and Net Gifts*, which may be obtained from the Internal Revenue Service.

Powers of appointment. The charitable deduction is allowed for property passing to charity by the exercise, release, or lapse of a power of appointment, if the property is included in the decedent's gross estate.

Partial interests. If an interest in property passes or has passed from the decedent for charitable purposes and an interest (other than an interest which is extinguished upon the decedent's death) in the same property passes or has passed from the decedent for private purposes (for less than an adequate and full consideration in money or money's worth), no deduction is allowed for the value of the interest which passes for charitable purposes unless the interest is deductible under (1) through (6) that follow. If at the date of a decedent's death, a transfer for private purposes is dependent upon the performance of some act or the happening of some precedent event in order to be effective, the interest is considered to pass for a private purpose unless the possibility of the event or occurrence is so remote as to be negligible.

1) ***An undivided portion of the decedent's entire interest.*** If the decedent, at death, transferred for a charitable purpose an undivided interest, ***not in trust,*** of the decedent's entire interest in property, the value of the interest is a deductible charitable contribution. An undivided portion of a decedent's entire interest in property must consist of a fraction, or a percentage, of each and every interest or right owned by the decedent in the property, and it must extend over the entire term of the decedent's interest in that property or in other property into which the donated property is converted.
2) ***Remainder interest in a personal residence.*** If the decedent at death transferred for a charitable purpose the remainder interest, ***not in trust,*** in the decedent's personal residence, the value of the interest is a deductible charitable contribution.

The term ***personal residence*** means any property used by the decedent as a residence, such as a vacation home, even though it is not used as a principal residence. The term also includes stock owned by the decedent as a tenant-stockholder in a cooperative housing corporation, if the dwelling the decedent was entitled to occupy was used by the decedent as a personal residence. A residence does not include household furnishings that are not fixtures. The charitable remainder interest must be in the residence itself and not in the proceeds to be derived from the sale of the residence.

3) ***Remainder interest in a farm.*** If the decedent, at death, transferred the remainder interest, ***not in trust,*** in a farm to a qualified charity, the value of that interest is deductible.

A farm for this purpose means ***any*** land used by the decedent, or by a tenant of the decedent, for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock. A ***farm*** includes improvements thereon.

4) ***Transfers of partial interests for conservation purposes.*** The following interests in property are deductible as a charitable contribution if they are made to a charitable organization exclusively for ***conservation*** purposes:

   a) A lease on, option to purchase, or easement with respect to real property granted in perpetuity, if made after June 13, 1977, and before June 14, 1981; or

   b) A remainder interest in real property, if made after June 13, 1976, and before June 14, 1981.

Conservation, for these purposes, is the preservation of land areas for public outdoor recreation or education, or scenic enjoyment; the preservation of historically important land areas or structures; or the protection of natural environmental systems.

5) ***Remainder interests, charitable remainder trusts, and pooled-income funds.*** A charitable deduction will be allowed for the transfer by the decedent of a remainder interest for a charitable purpose in certain cases. The charitable remainder must be in a trust, and the trust must be in the form of a charitable remainder annuity trust, or a charitable remainder unitrust, or a pooled-income fund.

In the case of a charitable remainder annuity trust and a charitable remainder unitrust, the governing instrument must provide that the obligation to pay the unitrust or annuity amount begins on the date of death, in order for the charitable interest to qualify for the estate tax charitable deduction. The instrument must also provide for corrective payments in the case of an underpayment or overpayment of an annuity or unitrust amount determined to be payable.

The rules in the preceding paragraph apply only in the case of transfers to charitable remainder trusts by decedents dying after May 5, 1980, except that they do not apply in the case of transfers under the terms of wills executed on or before May 5, 1980:

   a) If the decedent dies after May 5, 1980, but before May 5, 1981, without having amended any dispositive provision of a will after May 5, 1980, by codicil or otherwise;

   b) If the decedent dies after May 5, 1980, and at no time after that date had the right to change the portions of a will which pertain to the passing of the property to, or for the use of, an organization qualifying for a charitable contribution; or

   c) If no dispositive provision of the will is amended by the decedent, by codicil or otherwise, after May 5, 1980, and before May 5, 1981, and the decedent is on May 5, 1981, and at all times thereafter under a mental disability to amend the will by codicil or otherwise.

A charitable remainder annuity trust is a trust from which a specified amount (not less than 5% of the initial net fair market value of the property placed in trust) is paid at least annually to one or more persons (who were living at the time the trust was created). At the death of the last income beneficiary, or at the end of a term of years (not greater than 20 years), the remainder interest must be held for the benefit of, or paid to, a qualified charitable organization.

Generally, a ***charitable remainder unitrust*** is a trust from which a fixed percentage (but not less than 5%) of the net fair market value of its assets, valued annually, is paid at least annually to one or more persons (who are living at the time of the creation of the trust). At the death of the beneficiaries or at the end of a term of years (but not greater than 20 years), the remainder interest is held for the benefit of, or paid to, a qualified charitable organization.

A pooled-income fund is a trust maintained by a charity to which an individual transfers property providing a proportionate income interest in all the property to a beneficiary for the life of an individual living at the time of the decedent's death.

Any other form of charitable remainder interest will not qualify for the charitable deduction.

6) ***Income interests, guaranteed annuity interests, and unitrust interests.*** If the decedent transfers an ***income interest,*** whether or not in trust, to a charity and the remainder to a noncharitable entity, the charitable deduction is disallowed, unless the income interest is in the form of a guaranteed annuity interest or unitrust interest.

The term ***guaranteed annuity interest*** is the right, pursuant to the instrument of transfer, to receive a determinable amount paid at least annually, for a specified term, or for the life or lives of an individual or individuals, each of whom is living at the date of death of the decedent.

For example, the annuity may be paid for the life of an individual plus a term of years. An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the appropriate valuation date.

A ***guaranteed annuity interest***, not in trust, must be paid by an insurance company or by an organization regularly engaged in issuing annuity contracts.

The term ***unitrust interest*** means the right, pursuant to the instrument of transfer, to receive payment, not less often than annually, of a fixed percentage of the net fair market value, determined annually, of the property which funds the unitrust.

A unitrust interest, not in trust, must be paid by an insurance company or by an organization regularly engaged in issuing interests otherwise meeting the requirements of a unitrust interest.

Partial interests, valuation. The amount of the deduction in the case of a partial interest (including a remainder interest) is the fair market value of the interest on the appropriate valuation date. The fair market value of an annuity, life estate, term for years, remainders, reversion, or unitrust interest is its present value.

If the valuation of the interest involved is dependent upon the continuation or termination of more than one life, or upon a term certain concurrent with one or more lives, a special factor must be used. Many of these factors may be found in, or are readily computed with, the use of Publications 723, 723A, and 723B, which may be purchased from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402. If, however, a special factor is required in the case of an actual transaction, the Commissioner of Internal Revenue may furnish the factor upon request. See Part IV for the procedure for requesting actuarial factors.

State or foreign death taxes. For treatment of state or foreign death taxes imposed on a transfer to a charity, see the discussion under Section 9(A), *Administration Expenses, Funeral Expenses, Claims, and Obligations,* and Section 11(B), *Credit for State Death Taxes.*

Where listed. Charitable transfers are listed on Schedule O, Form 706.

10. Computation and Rates of the Estate Tax

To summarize Section 9, the taxable estate is the ***total gross estate*** less:

1) Administration and funeral expenses;
2) Claims against the estate and obligations;
3) Casualty and theft losses;
4) Orphans' deduction;
5) Marital deduction; and
6) Charitable deduction.

Tax Rate Schedule

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53 percent of the excess of such amount over $2,500,000.
Over $3,000,000 but not over $3,500,000	$1,290,800, plus 57 percent of the excess of such amount over $3,000,000.
Over $3,500,000 but not over $4,000,000	$1,575,800, plus 61 percent of the excess of such amount over $3,500,000.
Over $4,000,000 but not over $4,500,000	$1,880,800, plus 65 percent of the excess of such amount over $4,000,000.
Over $4,500,000 but not over $5,000,000	$2,205,800, plus 69 percent of the excess of such amount over $4,500,000.
Over $5,000,000	$2,550,800, plus 70 percent of the excess of such amount over $5,000,000.

The estate tax before the allowance of any credit is an amount equal to the excess, if any, of:

1) A tentative tax on the sum of—
   a) The amount of the taxable estate, and
   b) The amount of the ***adjusted taxable gifts;***

   Over

2) The total amount of ***tax payable*** with respect to gifts made after 1976.

The ***adjusted taxable gifts*** include only the value of the taxable gifts made by the decedent after 1976, that are ***not includible*** in the decedent's gross estate. For example, taxable gifts made after 1976 but within 3 years of the decedent's death are not considered adjusted taxable gifts to be included in the decedent's gross estate because they are already included in the tax computation.

The tax payable on gifts made after 1976 for estate tax purposes is the amount by which the gift tax payable exceeds the appropriate unified credit amount.

Adjustment for gift tax paid by spouse. If the decedent made a gift, one-half of which was considered made by the decedent's spouse, and the amount of the gift is includible in the decedent's gross estate, any tax payable by the spouse is treated as a tax payable on a gift made by the decedent, and therefore, is included as an offset against the tentative estate tax.

Split gifts made within 3 years of death of spouse. A gift is not included in computing the adjusted taxable gifts (lifetime transfers) of a decedent if:

1) The decedent's spouse was the donor of a gift (one-half of which was considered as made by the decedent), and
2) The gift was included in the gross estate of the decedent's spouse as a ***transaction within 3 years of death.***

Also, the ***total tax payable with respect to gifts made after 1976*** is reduced by the amount of gift tax payable that was treated as a tax payable for the gift made by the decedent's spouse.

The tentative tax is computed according to the Tax Rate Schedule included in this section.

Special benefit for certain U.S. military personnel. This benefit is provided for U.S. military personnel who die as a result of service in a combat zone. The decedent must have been a U.S. resident and must have died during active service. Death must have been caused by wounds, injury, or disease suffered in a combat zone, and while in line of duty, by reason of a hazard to which the individual was subjected as an incident of such service.

The estates of servicemen, ***missing in action during the Vietnam conflict,*** who are determined to have been killed in action, regardless of the date of the determination, also qualify for this benefit.

The benefit provides an exemption from the additional estate tax, but not from the basic tax. The basic estate tax is 125% of the maximum state death tax credit. (See Section 11(B), *Credit for State Death Taxes.*) The additional estate tax is the difference between:

1) The federal estate tax (before credits), computed by using the following table; and
2) The basic estate tax.

Note. The unified credit (described in Section 11(A)) applies to the estates of servicemen determined to have been killed in action after December 31, 1976. Hence, the estates of servicemen killed after 1976, and before 1978, will not be liable for federal estate tax when the maximum state death tax credit is allowable unless the taxable estate exceeds $2,265,000 ($825,000 in a jurisdiction that has no state death tax).

The computation for a decedent declared dead in 1977 is illustrated as follows:

Taxable estate	$2,265,000
Subtract $60,000	(60,000)
Adjusted taxable estate	$2,205,000
Maximum credit for state death taxes under sec. 2011	$120,000
Multiply by 125%	×1.25
Federal estate tax	$150,000
Less: Unified credit for 1977	(30,000)
	$120,000
Less: Credit for state death taxes under sec. 2011	(120,000)
Federal estate tax liability	-0-

Thus, the estate of a serviceman declared dead in 1977 will not be liable for federal estate tax if the maximum state death tax credit under section 2011 of the Code is allowable and the taxable estate is less than $2,265,000 ($825,000 in a jurisdiction that has no state death tax). An estate tax return, however, must be filed for a decedent who died in 1977 when the gross estate exceeds $120,000. (This amount increases to $134,000 in 1978, $147,000 in 1979, $161,000 in 1980, and to $175,000 in 1981 and thereafter.)

Examples of the estate tax computation are contained in Section 11(G), Examples of Estate Tax Computation.

11. Credits Against the Tax

After subtracting the tax payable on gifts made after 1976 from the tentative tax, the following credits are deducted to determine the ***net estate tax payable:***

1) Unified credit;
2) Credit for state death taxes;
3) Credit for gift taxes;
4) Credit for tax on prior transfers; and
5) Credit for foreign death taxes.

Maximum Credit For State Death Taxes

If the adjusted taxable estate is:	The maximum tax credit shall be:
Not over $90,000	8/10ths of 1% of the amount by which the adjusted taxable estate exceeds $40,000.
Over $90,000 but not over $140,000	$400 plus 1.6% of the excess over $90,000.
Over $140,000 but not over $240,000	$1,200 plus 2.4% of the excess over $140,000.
Over $240,000 but not over $440,000	$3,600 plus 3.2% of the excess over $240,000.
Over $440,000 but not over $640,000	$10,000 plus 4% of the excess over $440,000.
Over $640,000 but not over $840,000	$18,000 plus 4.8% of the excess over $640,000.
Over $840,000 but not over $1,040,000	$27,600 plus 5.6% of the excess over $840,000.
Over $1,040,000 but not over $1,540,000	$38,800 plus 6.4% of the excess over $1,040,000.
Over $1,540,000 but not over $2,040,000	$70,800 plus 7.2% of the excess over $1,540,000.
Over $2,040,000 but not over $2,540,000	$106,800 plus 8% of the excess over $2,040,000.
Over $2,540,000 but not over $3,040,000	$146,800 plus 8.8% of the excess over $2,540,000.
Over $3,040,000 but not over $3,540,000	$190,800 plus 9.6% of the excess over $3,040,000.
Over $3,540,000 but not over $4,040,000	$238,800 plus 10.4% of the excess over $3,540,000.
Over $4,040,000 but not over $5,040,000	$290,800 plus 11.2% of the excess over $4,040,000.
Over $5,040,000 but not over $6,040,000	$402,800 plus 12% of the excess over $5,040,000.
Over $6,040,000 but not over $7,040,000	$522,800 plus 12.8% of the excess over $6,040,000.
Over $7,040,000 but not over $8,040,000	$650,800 plus 13.6% of the excess over $7,040,000.
Over $8,040,000 but not over $9,040,000	$786,800 plus 14.4% of the excess over $8,040,000.
Over $9,040,000 but not over $10,040,000	$930,800 plus 15.2% of the excess over $9,040,000.
Over $10,040,000	$1,082,800 plus 16% of the excess over $10,040,000.

A) Unified Credit

The amount of the unified credit allowed the estates of individuals dying in 1977 is $30,000. The credit is increased as follows:

For individuals dying in:	The credit is:
1978	$34,000
1979	$38,000
1980	$42,500
1981 and thereafter	$47,000

Transitional rule. The amount of the unified credit available must be reduced by 20% of the amount of the ***specific lifetime exemption*** allowed for gifts made after September 8, 1976, and before 1977.

Example. If an individual died in 1979, and had made no prior gifts, the amount of the available unified credit against the tentative estate tax normally would be $38,000. However, if the decedent had made a taxable gift of $15,000 on October 1, 1976, and elected to use $15,000 of the available lifetime exemption for the gift, as provided under prior law, the unified credit available to the decedent's estate would be $35,000 ($38,000 − $3,000 (20% × $15,000)) rather than the full $38,000.

There is a transitional rule on the amount of the unified credit that may be taken for gifts made before July 1, 1977. This rule is discussed in Section 14(C), *Unified Credit,* of Part II.

The amount of the unified credit claimed may not exceed the amount of the tax imposed. Therefore, the excess unused unified credit may not be claimed as a refund.

B) Credit for State Death Taxes

The tentative tax may be reduced further if any estate, inheritance, legacy, or succession tax is ***actually paid*** to any state or the District of Columbia, on account of any property included in the gross estate of the decedent.

The maximum amount creditable for state death taxes is computed using the table included in this section.

The allowable credit is computed using the ***adjusted taxable estate,*** rather than the taxable estate. The ***adjusted taxable estate*** is the taxable estate reduced by $60,000.

The credit for state death taxes may not exceed the amount of the estate tax reduced by the unified credit.

Limitation. If a state imposes a death tax on a ***charitable transfer*** and a deduction is claimed for the tax, the credit for state death taxes is limited to the least of:

1) The amount of state death taxes paid less the amount of the deduction claimed;
2) The maximum credit allowable to the decedent's estate using the table for credit for state death taxes; or
3) $\frac{\text{All the state death taxes less those imposed on the charitable transfer}}{\text{All state death taxes}} \times$ The maximum credit computed without the deduction for state death taxes

Credit for death taxes on remainder. If the election is made to postpone the payment of any portion of the federal estate tax attributable to a remainder or a reversionary interest in property, the credit is allowed against that portion of the federal estate tax for state death taxes attributable to the reversionary or remainder interest, if the state death taxes are paid and claimed as a credit any time before the expiration of the time for payment.

Limitation period. The credit applies only to taxes that actually were paid and for which the credit was claimed within 4 years after filing the estate tax return.

If a timely petition for a redetermination of a tax deficiency has been filed with the Tax Court, the credit may be claimed within the 4-year period or 60 days after the Tax Court decision becomes final, whichever is later.

If an extension of time for paying the estate tax or a deficiency has been granted, the credit may be claimed by the later of the 4-year period or the expiration of the extended time for payment.

If a timely claim for refund of, or credit for, an overpayment of tax has been filed, the claim for the credit for state death taxes may be filed by the ***later of:***

1) The expiration of the normal 4-year period; or
2) 60 days from the date of a notice of the disallowance of any part of the claim for credit or refund; or
3) 60 days from the date a decision of any court of competent jurisdiction becomes final.

Refunds of estate tax based on the allowance of the state death tax credit are made without interest.

C) Credit for Gift Taxes

No credit is allowed for any gift tax paid on gifts made after 1976.

Gift made before 1977. Credit is allowed against the estate tax for the federal gift tax paid on a gift by a decedent of property subsequently included in the gross estate. The credit is allowable even though the gift tax is paid after the decedent's death and the amount of the gift tax is deducted from the gross estate as a debt of the decedent.

The credit is allowed only when the gift tax has been paid on the transfer of nonprobate assets and double taxation would result.

Example 1. The decedent during life (before 1977) transferred all the interest in property to another and paid the gift tax on the transfer. The decedent died 2 years after the transfer. Because the transfer was made in contemplation of death, the value of the property transferred was included in the dece-

dent's gross estate although neither the property itself, nor any interest in it, were actually possessed by the decedent at death.

Therefore, the gift tax paid on this nonprobate property would be creditable against the estate tax.

Example 2. In contrast to the preceding example, assume the decedent transferred property to another and paid the gift tax on the transfer. However, the donee predeceased the decedent and the interest in the property reverted to the decedent. Upon the decedent's death, the value of the property was included in the decedent's gross estate because the decedent actually possessed the property at death.

The credit for the gift tax paid by the decedent is not available to the estate because the property was a probate asset actually possessed by the decedent at death.

Limitation. The credit is limited to the lesser of:

1) The gift tax paid on the gift that is included in the gross estate; or
2) The amount of estate tax attributable to the inclusion of the gift in the decedent's gross estate.

Limitation 1. If the gift included in the gross estate was the only one made in a given calendar quarter (or calendar year, if made before 1971), the amount under limitation (1) is the gift tax paid for that quarter (or year, if made before January 1, 1971). If the included gift is only one of several made in a given calendar quarter (or year, if pre-1971), the amount under limitation (1) is a fraction of the gift tax paid for that quarter (or year, if a pre-1971 gift); the numerator being the amount of the included gift reduced by any portion excluded or deducted; and the denominator being the total taxable gifts increased by the $30,000 specific exemption allowed. The values used are those determined for purposes of the gift tax.

Example. Assume that the included gift was valued at $63,000 for gift tax purposes and that an exclusion of $3,000 was applicable; that the total amount of taxable gifts was $210,000 after deduction of a specific exemption of $30,000; and that the gift tax paid was $40,275. The amount under ***limitation (1)*** would be computed as follows:

$$\frac{\$\ 63{,}000 - \$3{,}000}{\$210{,}000 + \$30{,}000} \times \$40{,}275 = \$10{,}068.75$$

Limitation 2. The amount under limitation (2) is a fraction of the gross estate tax reduced by any credit for state death taxes. The numerator is the value of the gift, and the denominator is the value of the entire gross estate reduced by any amount allowed as charitable and marital deductions. For this purpose, the ***value of the gift*** is the value included in the gross estate, or the value for purposes of the gift tax, whichever is lower, reduced by all or a portion of any annual exclusion allowed for gift tax purposes and by any amount allowed as charitable and marital deductions. If the gift tax value is lower than the estate tax value, it is reduced by the amount of the entire exclusion. If the estate tax value is lower, it is reduced by only a portion of the exclusion that is computed by multiplying the estate tax value of the gift by a fraction, the numerator being the annual exclusion and the denominator being the gift tax value.

Example. Assume that a gift by the decedent, valued at $30,000 for gift tax purposes, is included in his gross estate at a value of $27,000, and that an exclusion of $3,000 had been allowed. The value of the gift for this purpose would be:

$$\$27{,}000 - \left[\frac{\$3{,}000}{\$30{,}000} \times \$27{,}000\right] = \$24{,}300.$$

If a charitable or marital deduction were allowed the estate in this example, the amount of the gift also would have to be reduced by a proportionate part of any such deduction.

D) Credit for Tax on Prior Transfers

Credit is allowed against the tax for federal estate taxes paid on the transfer of property to the present decedent from a transferor who died within 10 years before, or within 2 years after, the present decedent's death. The transfer includes the transfer of a beneficial interest in property and the transfer or nontransfer by the exercise or nonexercise of a general power of appointment. It is not necessary that the transferred property be identified in the present decedent's estate or that it be in existence at the time of death. It is sufficient that the transfer of the property to this decedent was subject to federal estate tax in the estate of the transferor and that the transferor died within the prescribed period of time.

Limitation. The credit is limited to the smaller of the following amounts:

1) The amount of the federal estate tax attributable to the transferred property in the transferor's estate; or
2) The amount of the federal estate tax attributable to the transferred property in the present decedent's estate.

Percentage allowable. If the transferor died within 2 years before, or 2 years after, the present decedent's death, the credit is the smaller of limitation (1) or (2). If the transferor died more than 2 years before the decedent, the credit is a percentage of the smaller of either limitation (1) or (2) as follows:

a) 80%, if the transferor died within the 3rd or 4th year preceding the decedent's death;
b) 60%, if within the 5th or 6th year;
c) 40%, if within the 7th or 8th year;
d) 20%, if within the 9th or 10th year.

Limitation 1. The amount of limitation (1) is a fraction of the transferor's adjusted federal estate tax, the numerator being the value of the transferred property, and the denominator being the transferor's adjusted taxable estate

The transferor's adjusted federal estate tax is the amount of federal estate tax paid on the transferor's estate, plus any credit allowed the estate for gift tax, and any credit allowed the estate for tax on prior transfers, but only if the transferor acquired property from a person who died within 10 years before the death of the present decedent.

The transferor's adjusted taxable estate is the amount of the transferor's taxable estate decreased by the amount of any death taxes paid with respect to the gross estate (and increased by the amount of the exemption, $60,000, allowed in computing the taxable estate if the transferor died before 1977). The ***death taxes,*** for this purpose, are the federal estate tax plus the net amount of all other estate, inheritance, legacy, succession, or similar taxes imposed by and paid to, any taxing authority, whether within or without the United States.

The value of the transferred property is the value used to determine the estate tax liability of the transferor's federal estate tax liability, reduced by:

1) The amount of any death taxes payable out of, or paid by the decedent in connection with, the transferred property;
2) The amount of any encumbrance on the property or obligation imposed by the transferor upon, and incurred by the present decedent with respect to, the property; and
3) The amount of any marital deduction allowed the transferor's estate if the decedent was the transferor's spouse at the time of the transferor's death.

Limitation 2. The amount of limitation (2) is the difference between:

1) The net estate tax payable on the present decedent's estate, determined without regard to the ***credit for tax on prior transfers,*** and without regard to any credit for foreign death taxes claimed under the provisions of a death tax convention; and
2) The net estate tax determined in a similar manner, but computed after subtracting from the present decedent's gross estate, the value of the property transferred.

If a charitable deduction is allowable to the estate of the present decedent, the charitable deduction otherwise allowable is reduced by an amount having the same ratio to that charitable deduction as the value of the transferred property has to the value of the present decedent's adjusted gross estate. If a marital deduction is allowable, it is limited to 50% of the reduced adjusted gross estate or $250,000, whichever is greater, for the purpose of computing the net estate tax.

Certain real property. If the gross estate of the transferor included real property, such as a farm or other closely held business, for

which the special real property election was made (as discussed in Section 8(G), *Special Farm or Other Closely Held Business Real Property Valuation*, of this Part), and if the additional estate tax is imposed on the transferor's estate within 2 years of the decedent's death because of the termination of the special use, the additional tax is treated as a federal estate tax payable with respect to the estate of the transferor. Further, the value of such property and the amount of the transferor's taxable estate is determined as if the special valuation had not been elected.

Generation-skipping transfer. If there was a generation-skipping transfer of any property included in the decedent's estate, and if ***the deemed transferor was not alive*** at the time of the transfer, the property is considered to have passed to the decedent from the deemed transferor. Generation-skipping transfers are discussed further in Part III.

The tax on the generation-skipping transfer in such circumstances, is treated as a federal estate tax payable by the deemed transferor's estate and the deemed transferor's taxable estate shall be increased by the value of such property used to determine the generation-skipping tax.

Where figured. The credit for taxes on prior transfers is figured on Schedule Q, Form 706.

E) Credit for Foreign Death Taxes

Credit is allowed against the estate tax for any estate, inheritance, legacy, or succession taxes actually paid by the decedent's estate to any foreign country. The term ***foreign country*** includes possessions or political subdivisions of foreign states and possessions of the United States.

The credit is allowed for death taxes paid with respect to property:

1) Situated within the foreign country to which the tax is paid; and
2) Included in the decedent's gross estate.

No credit is allowed for such taxes paid with respect to the estate of a person other than the decedent. No credit is allowed for interest or penalties relating to foreign death taxes.

The credit is allowable to the estate of a decedent who, at the time of death, was a citizen of the United States. It also is allowable to the estate of a decedent who was a resident but not a citizen of the United States at the time of death, unless a proclamation by the President of the United States denies the foreign death tax credit to citizens of the foreign country of which the decedent was a citizen. No credit is allowable to the estate of a decedent who was neither a citizen nor resident of the United States at the time of death.

Whether particular property included in a decedent's gross estate is situated in the foreign country imposing the tax is determined according to the same principles used in determining whether similar property of a nonresident alien decedent is situated within the United States for federal estate tax purposes. (See Section 12(A), *Situs of Property*.) If the tax is imposed by a political subdivision of a foreign country, the tax credit may be allowed even though, under the foregoing principles, the property involved is situated in a political subdivision different from the one imposing the tax.

Limitation. The credit is limited to the lesser of the following:

1) The amount of the foreign death tax attributable to the property situated in the country imposing the tax and included in the decedent's gross estate for federal estate tax purposes; or
2) The amount of the federal estate tax attributable to particular property situated in a foreign country, subject to death tax in that country, and included in the decedent's gross estate for federal estate tax purposes.

Exchange rate. The appropriate rate of exchange to be used to convert death taxes paid to the foreign country into U.S. dollars, in order to compute the credit, is the rate of exchange in effect at the time each payment of foreign tax is made.

Limitation 1. The amount of limitation (1) is a fraction of the tax imposed by the foreign country, without allowance of any credit for U.S. estate tax. The numerator is the value of the property situated in the foreign country subjected to the foreign tax and included in the decedent's gross estate for federal estate tax purposes. The denominator is the value of all the property subjected to the foreign tax. The values used in this computation are those used by the foreign jurisdiction in imposing its tax. If a foreign country imposes more than one kind of death tax or imposes tax at different rates upon the several shares of an estate, or if a foreign country and a political subdivision or possession thereof each imposes a death tax, separate computations must be made and the results added to determine the amount of limitation (1).

Limitation 2. The amount of limitation (2) is a fraction of the gross federal estate tax reduced by the unified credit and any credit for death taxes and by any credit for gift tax. The numerator is the adjusted value of the property situated in the foreign country, subjected to the foreign death tax, and included in the gross estate. The denominator is the value of the entire gross estate, reduced by the total amount of the deductions allowed for ***charitable contributions*** and for bequests to the surviving spouse. The values used in this computation are those determined for purposes of the federal estate tax. The ***adjusted value of the property situated in the foreign country*** is the value of the property in the foreign country that meets the requirements for credit, reduced by the amount of any allowable charitable and marital deductions attributable to such property.

Example. A citizen of the United States, at the time of death (after 1980), left a gross estate consisting of shares of stock issued by a U.S. corporation valued at $750,000, and property situated in Country X valued at $250,000, on which death taxes were paid to Country X. Expenses, indebtedness, etc., amounted to $30,000. The decedent bequeathed $20,000 of the U.S. stocks and $50,000 of the property in Country X to a U.S. charity. The balance of the estate was bequeathed to his son. The gross federal estate tax is $306,800, the available unified credit is $47,000, and the credit for state death taxes is $27,600. The amount of limitation (2) is computed as follows:

$$\frac{\$250{,}000 - \$50{,}000}{\$1{,}000{,}000 - \$70{,}000} \times (\$306{,}800 - \$47{,}000 - \$27{,}600) = \$49{,}923$$

Death tax conventions and the credit. In addition to the credit for foreign death taxes under the provisions of federal estate tax law, similar credits are allowed under death tax conventions with a number of foreign countries, discussed later.

If credit is allowable either under the provisions of law or under the provisions of a convention, that credit is allowed which is most beneficial to the estate. If property of the estate is subjected to tax by a country with which the United States has concluded a convention, and also by a political subdivision or possession of that country, there is allowed:

1) A credit for the combined death taxes paid to the foreign country and its political subdivisions or possessions as provided for by the convention;
2) A credit for the combined death taxes paid to the foreign country and its political subdivisions or possessions as determined under the provisions of law; or
3) A credit for that amount of the combined death taxes paid to the foreign country and its political subdivisions or possessions as allowed under the convention, and a further credit, determined in the regular manner, for the death taxes paid to each political subdivision or possession to the extent the death taxes are not directly or indirectly covered by the convention,

whichever is the most beneficial to the estate.

Taxes imposed by two foreign countries. It is possible, in certain cases, for a credit to be allowable for the same property, as regularly determined, for tax paid to one foreign country and as regularly determined or under a convention for tax paid to another foreign country. In such cases, the credits are combined and the total amount is credited against the federal estate tax. The amount allowable is limited, however, to the amount of the federal estate tax attributable to the property involved, determined according to the rules for computing the amount of limitation (2).

Note. If the foreign death taxes that are paid on charitable transfers are deducted rather

than credited, the value of that property is ***excluded*** in computing limitation (1) and (2).

Credit for death taxes on remainders. If the election is made to postpone the payment of any portion of the federal estate tax attributable to a remainder or reversionary interest in property, the credit is allowed against that portion of the federal estate tax for foreign death taxes attributable to the reversionary or remainder interest if the foreign death taxes are paid and claimed as a credit anytime before the expiration of the time for payment.

Limitation period. The credit for foreign death taxes is limited to those taxes that actually were paid, and for which a credit was claimed within the later of the 4 years after the filing of the estate tax return, or before the date of expiration of any extension of time for paying the federal estate tax, or 60 days after a final decision of the Tax Court on a timely filed petition for a redetermination of a deficiency.

Where figured. The credit for foreign death taxes is figured on Schedule P, Form 706. Form 706CE, *Certification of Payment of Foreign Death Tax*, is also required.

F) Recovery of Taxes Claimed as Credits

If any amount of taxes claimed as a credit for state death taxes or for foreign death taxes is refunded, the executor or administrator, or any other person recovering the amount must notify the Director with whom the estate tax return was filed within 30 days of receipt in order that the federal estate tax may be redetermined. No interest is assessed on any amount of tax refunded for foreign taxes paid, except to the extent the foreign country paid interest on the refund. Any federal estate tax found to be due as a result of the refund is payable by the person receiving the refund even if the refund is received after the expiration of the period of limitations. The notice shall include—

1) The name of the decedent;
2) The date of death;
3) The property with respect to which the refund was made;
4) The amount of the refund exclusive of interest;
5) The date of the refund; and
6) The name and address of the person receiving the refund.

G) Examples of Estate Tax Computation

The following examples illustrate the computation of the estate tax.

Example 1. Robert Jones died in 1979. His gross estate is valued at $800,000. He made no lifetime taxable gifts. His surviving spouse is to receive all the assets of the estate. The estate tax is computed as follows:

Gross estate	$800,000
Less: Debts and administration expenses	200,000
Adjusted gross estate	$600,000
Less: Marital deduction	250,000
Taxable estate	$350,000
Add: Adjusted taxable gifts	0
Taxable interests	$350,000
Tentative tax on taxable interests	$104,800
Less: Tax payable on gifts made after 1976	0
Estate tax before credits	$104,800
Less: Unified credit	38,000
Estate tax after unified credit	$ 66,800
Less: State death tax credit (based upon adjusted taxable estate of $290,000)	5,200
Net estate tax	$ 61,600

Example 2. Bill Smith dies in 1985 leaving a taxable estate of $500,000. His gifts were as follows:

In 1975, $53,000 to his son
In 1978, $153,000 to his daughter
In 1979, $23,000 to his son

The gift tax computations for these gifts are found in Section 15, *Computation and Rates of the Federal Gift Tax*, of Part II. The adjusted taxable gifts after 1976 are $170,000 ($150,000 + $20,000) and the gift tax payable on these gifts is $9,800 ($7,400 + $2,400). The estate tax is computed as follows:

Taxable estate	$500,000
Add: Adjusted taxable gifts	170,000
Taxable interests	$670,000
Tentative tax on taxable interests	$218,700
Less: Tax payable on gifts made after 1976	9,800
Estate tax before credits	$208,900
Less: Unified credit	47,000
Estate tax after unified credit	$161,900
Less: State death tax credit (based upon adjusted taxable estate of $440,000)	10,000
Net estate tax	$151,900

Example 3. Assume the same facts as Example 2, except that Bill Smith dies in 1981. Thus, the gift in 1979 of $23,000 was made within 3 years of death and is included in the gross estate along with the gift tax paid on the gift of $2,400. The estate tax is computed as follows:

Taxable estate	$525,400
Add: Adjusted taxable gifts	150,000
Taxable interests	$675,400
Tentative tax on taxable interests	$220,698
Less: Tax payable on gifts made after 1976	9,800
Estate tax before credits	$210,898
Less: Unified credit	47,000
Estate tax after unified credit	$163,898
Less: State death tax credit (based upon adjusted taxable estate of $465,400)	11,016
Net estate tax	$152,882

12. Estates of Nonresidents, Not Citizens

The entire gross estate, wherever situated, of a decedent who, at the time of death, was not a resident or citizen of the United States, is made up in the same way as the gross estate of a citizen or resident of the United States. However, only that part of the entire gross estate that is situated in the United States is subject to the tax. Rules for determining the location of property are set forth here along with the different rules concerning the allowable deductions and credits with regard to estates of nonresident aliens.

Decedents are considered nonresidents not citizens of the United States, if they last resided in a U.S. possession and were U.S. citizens solely by reason of their birth, residence, or citizenship in the possession. In such cases, the estates are taxed as estates of nonresidents, not citizens of the United States.

A) Situs of Property

Property of a decedent who, at time of death, was neither a citizen nor a resident of the United States is considered situated in the United States if the property is:

1) Real property located in the United States;
2) Tangible personal property located in the United States, such as clothing, jewelry, automobiles, furniture, or currency. Exception is made for works of art imported into the United States solely for public exhibition purposes;
3) A debt obligation of a citizen or resident of the United States, a domestic partnership or corporation, any estate or trust (but not a foreign estate or trust), the United States, a state or any political subdivision thereof, or the District of Columbia (however, see the exceptions in the following paragraphs); or
4) Shares of stock issued by domestic corporations.

However, the personal effects of a nonresident alien who dies while in transit through the United States are not considered situated in the United States. Neither is merchandise that happens to be in transit through the United States when a nonresident alien dies considered to be situated in the United States.

Property that the decedent transferred before death, but that is includible in the gross estate is considered situated in the United States if it is determined, under the rules listed earlier, to be so situated either at the time of the transfer or at the time of the decedent's death.

Property not situated in the United States. Notwithstanding the above rules, property of decedents who, at the time of their death, were neither citizens nor residents of the United States, is ***not*** considered situated in the United States if it is:

1) A deposit with a U.S. bank, if the deposit was not connected with a U.S. trade or business and was paid or credited to the decedent's account;
2) A deposit or withdrawable account with a savings and loan association chartered and supervised under federal or state law,

or an amount held by an insurance company under an agreement to pay interest on it, if the deposit or amount was not connected with a U.S. trade or business and paid or credited to the decedent's account;

3) A deposit with a foreign branch of a U.S. bank, if the branch is engaged in the commercial banking business; or

4) A debt obligation of a domestic corporation any interest on which, if it had been received by the decedent at the time of death, would have been treated for income tax purposes as income from sources without the United States because less than 20% of the domestic corporation's gross income from all sources was derived from sources within the United States for the 3-year period (or applicable part thereof) ending with the close of the tax year of the corporation immediately preceding the decedent's death.

Shares of stock issued by a corporation that is not a domestic corporation are not considered property within the United States, even if the certificates are physically located in the United States.

Amounts receivable as insurance on the decedent's life are not considered property within the United States.

Tax conventions. The United States has concluded death tax conventions with a number of foreign countries to avoid double taxation. These conventions, in addition to making available to estates of citizens and residents of the United States credits for death taxes paid to the foreign countries involved, provide certain rules for the determination of the situs of property. These rules, which in some cases differ from those set forth earlier, are used in the determination of the credit allowable to estates of citizens and residents and for the purpose of determining the property includible in the estates of nonresident, non-citizen decedents who come within the scope of the conventions. The following list shows the countries with which conventions are in force, and the nonresident aliens to whose estates the rules of situs in the conventions apply.

Australia—Domiciliary of Australia

Canada—Domiciliary of Canada—However, the death duty convention between the U.S. and Canada is not applicable to estates of individuals dying after 1971

Finland—Resident of Finland—Also if a beneficiary of the decedent's estate was a resident of Finland

France—Domiciliary of France

Greece—Domiciliary of Greece

Ireland—Domiciliary of Ireland

Italy—National or Domiciliary of Italy

Japan—Decedent having a beneficiary of his estate domiciled in Japan

Netherlands—Domiciliary or resident of the Netherlands

Norway—Citizen or Domiciliary of Norway

South Africa—Ordinary Resident of South Africa

Switzerland—No situs rules for purposes of imposition of tax

United Kingdom—Domiciliary of United Kingdom

Additional information about the conventions may be obtained from the Internal Revenue Service.

Transfers within 3 years of death. If the decedent made a transfer within 3 years of death, in trust or otherwise, of property situated in the United States at the time of the transfer, or situated in the United States at the time of death, the property is considered situated in the United States for estate tax purposes.

B) Separate Unified Tax Rate

The computation of the tax on the taxable portion of the estate of a decedent not a resident and not a citizen of the United States is similar to the computation of the tax on estates of decedents who are U.S. citizens or residents. An estate tax must be computed and then be reduced by certain credits.

The estate tax, before the allowance of any credits, is an amount equal to the excess, if any, of:

1) The tentative tax on the sum of—
   a) The amount of the taxable estate, and
   b) The amount of the ***adjusted taxable gifts;***

Over:

2) The tentative tax on the amount of the ***adjusted taxable gifts.***

The adjusted taxable gifts are the total amount of the taxable gifts made by the decedent after December 31, 1976, other than gifts includible in the decedent's gross estate.

Adjustment for certain gift tax. If the decedent was the donor of any gift, one-half of which was considered as made by the decedent's spouse and the amount of the gift is includible in the decedent's gross estate, any gift tax payable by the spouse is treated as a tax payable with respect to a gift made by the decedent.

The tentative tax is computed according to the following tax rate schedule:

If the amount with respect to which the tentative tax is to be computed is:	The tentative tax is:
Not over $100,000	6% of such amount.
Over $100,000 but not over $500,000	$6,000, plus 12% of excess over $100,000.
Over $500,000 but not over $1,000,000	$54,000, plus 18% of excess over $500,000.
Over $1,000,000 but not over $2,000,000	$144,000, plus 24% of excess over $1,000,000.
Over $2,000,000	$384,000, plus 30% of excess over $2,000,000.

C) Separate Unified Credit

A $3,600 credit against the tax is provided for the estate of a nonresident not a citizen of the United States.

However, a special rule applies if decedents are considered nonresidents not citizens of the United States because they last resided in a U.S. possession and were U.S. citizens solely by their birth, residence, or citizenship in the possession. The estates of such individuals who died in 1979 may qualify for a credit that is the ***greater*** of:

1) $3,600; or

2) $11,680 multiplied by the ratio that the value, at death, of the part of the decedent's gross estate which is situated in the United States bears to the entire value of the decedent's gross estate. The $11,680 amount is increased for succeeding years as follows:

For individuals dying in:	The $11,680 is increased to:
1980	$13,388
1981 and thereafter	$15,075

In no case may the credit exceed the amount of the estate tax.

D) Other Credits

The credits for state death taxes including death taxes on remainders, gift tax, and the tax on prior transfers also are allowable to the estates of nonresidents, not citizens. If any tax that is claimed as a credit is recovered, the estate tax must be redetermined.

No credit is allowable for foreign death taxes.

The allowable credits are determined in the same manner that these credits are determined for the estates of citizens and residents of the United States.

The maximum state death tax credit allowed against the gross estates of nonresident aliens is proportionate to the value of the property upon which state death taxes were paid over the total value of the gross estate for federal estate tax purposes.

E) The Taxable Estate

The taxable estate of every nonresident not a citizen is determined by deducting from the gross estate (as discussed in the beginning of this section) the following:

Expenses, indebtedness, taxes, and losses. These items may be deducted proportionately. The deductible portion of each item is limited to the amount of each item multiplied by a fraction, the ***numerator*** being the value of the property situated in the United States, and the ***denominator*** being the value of the entire gross estate, wherever situated.

Transfer for public, charitable, and religious uses. The amount of all bequests, legacies, devises, or transfers, including any interest that falls into such transfers as a result of an

irrevocable disclaimer made before the due date for filing the estate tax return, is deductible if the transfer is made:

1) To, or for, the use of the United States, any state, any political subdivision thereof, or the District of Columbia, for exclusively public purposes;
2) To, or for, the use of any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, which is not disqualified for tax exemption because of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office; or
3) To a trustee or trustees, or fraternal society, order, or association operating under the lodge system, but only if such contributions or gifts are to be used within the United States by such trustee or trustees, or by such fraternal society, order, or association exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals; and such organizations would not be disqualified for tax exemption because of attempting to influence legislation, and such trustee or trustees, or such fraternal society, order, or association, does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

The deductions are computed in the same manner as similar deductions allowed the estates of U.S. citizens or residents.

These provisions may be modified by the death tax conventions the United States has with some foreign countries.

No deduction is allowed unless the executor or administrator discloses in the estate tax return the value of that part of the gross estate not situated in the United States.

Power of appointment. If property is includible in the decedent's estate because the decedent exercised, held, or released a power of appointment over such property, and the property is thereby given to a qualified organization, such transfer is considered a bequest by the decedent.

Death taxes payable out of bequests. If any amount of estate, succession, legacy, or inheritance taxes is payable wholly or partly out of deductible bequests, legacies, or devises, the amount deductible as a charitable deduction must be reduced by the amount of death taxes payable.

Limitation. The amount of the charitable deductions may not exceed the value of the transferred property required to be included in the gross estate.

F) Expatriation to Avoid Tax

A special tax computation is required for the estates of certain decedent nonresidents, not citizens of the United States, who, within the 10-year period ending with the date of death, lost U.S. citizenship. The computation does not apply, however, if the decedent's loss of U.S. citizenship did not have the avoidance of federal estate, gift, or income taxes as one of its principal purposes.

The Internal Revenue Service must establish only that it is reasonable to believe that an individual's loss of U.S. citizenship would, but for the special tax computation discussed here, result in a substantial reduction in the estate, inheritance, legacy, and succession taxes on the transfer of the estate of the individual. Once this has been established, the burden of proving otherwise is on the executor of the estate of the decedent expatriate.

The special tax computation does not apply, however, where the loss of U.S. citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended.

For the estates of decedent expatriates, subject to the special tax computation, the gross estate (except for certain stock in foreign corporations) is made up in the same way as the gross estate of any other nonresident, not a citizen. Estates of decedent expatriates must use the Tax Rate Schedule used by estates of U.S. citizens and residents.

The expatriate's estate is allowed a credit of $13,000 against the tentative tax. This credit cannot exceed the amount of the tax liability.

The other credits allowable to the estates of nonresidents who are not U.S. citizens are allowable to the estates of expatriates.

Foreign corporation stock. In addition to property considered situated in the United States under the situs rules discussed earlier in *A) Situs of Property*, the value of an expatriate decedent's gross estate, if certain stock ownership tests are met, includes a proportionate part of the fair market value of foreign corporation stock owned by the decedent at the time of death. This part is based on the value that the foreign corporation's property having a U.S. location bears to the fair market value of all corporation property, wherever located. The stock ownership tests referred to, both of which must be met, are as follows:

1) The decedent owned (directly or through a foreign corporation, partnership, trust, or estate) at death 10% or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation; and
2) The decedent owned (directly or constructively) at death more than 50% of the total combined voting power of all classes of stock entitled to vote in the foreign corporation.

In determining whether or not the more-than-50% test has been met, stock that the decedent directly or indirectly owned, as described in (1), is added to stock that the decedent is considered to have owned at death because of constructive ownership (that is, ownership attributed to the expatriate for stock held by members of the decedent's family, as well as by partnerships, trusts, estates, or corporations in which the decedent had certain interests). Note that the same shares of stock may not be counted more than once in determining whether the more-than-50% test has been met.

G) Application of Pre-1967 Estate Tax Provisions

For nonresident decedents, not citizens of the United States, special rules apply if there is in effect a proclamation by the President of the United States based on findings that:

1) The foreign country of which the decedent was a resident, in connection with the transfer of estates of U.S. citizens who were ***not*** residents of the foreign country, imposes a tax which is more burdensome than that imposed under our laws on the transfer of estates of decedents who were not U.S. citizens and who ***were*** residents of the foreign country;
2) Such foreign country, when requested by the United States to do so, has not acted to revise or reduce the tax imposed by it; and
3) It is in the public interest to apply pre-1967 tax provisions to the transfer of estates of decedents who were residents of the foreign country.

These special rules apply to individuals who died after the date of a Presidential proclamation. The special rules cease to apply after the date of a subsequent Presidential proclamation providing in effect that the pre-1967 provisions are no longer to be applied to transfers of estates of nonresident non-citizen decedents who were residents of the foreign country.

13. Executors and Administrators

Generally, an ***executor*** is named in a decedent's will to administer the estate and make distribution of properties as the decedent has directed. An ***administrator*** is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. In general, an executor and an administrator perform the same duties and have the same responsibilities.

If there is no executor or administrator appointed, qualified and acting within the United States, the term includes anyone in actual or constructive possession of any property of the decedent. It includes, among others, the

decedent's agents and representatives; safe-deposit companies, warehouse companies, and other custodians of property in this country; brokers holding securities of the decedent as collateral; and the debtors of the decedent who are in this country.

Duties. The primary duty of the executor or administrator is to collect all the assets of the decedent, to pay the creditors, and to distribute the remaining assets to the heirs or other beneficiaries. The executor or administrator is responsible for filing the estate tax return (and any income tax returns) when due and for paying the taxes determined, up to the date of discharge from duties. Additionally, the executor or administrator is required to retain records and supplemental data supporting the estate tax return. The prescribed forms, obtainable from the Internal Revenue Service, are required to be used in filing the estate tax return.

If the estate of a decedent is insufficient to pay all the decedent's debts, the debts due the United States must be paid first. The federal income tax liabilities of a decedent at the time of death, the income tax liability of an estate, as well as the estate tax liability are debts due the United States. The executor or administrator of an insolvent estate is personally responsible for any tax liability of the decedent or of the estate if he or she had notice of such tax obligations or had failed to exercise due care in determining if such obligations existed before distribution of the estate's assets and before being discharged from duties. The extent of such personal responsibility is the amount of any other payments made before paying the debts due the United States. The tax liabilities need not be formally assessed for the executor to be liable if he or she was aware or should have been aware of their existence.

Notice concerning fiduciary relationship. If you are appointed to act in any fiduciary capacity (as administrator, executor, or an ancillary representative) for another, you must file a written notice thereof with the Internal Revenue Service. Form 56, *Notice Concerning Fiduciary Relationship*, is provided for this purpose. The instructions and other requirements are given on the back of the form. File the written notice (or Form 56) with the Internal Revenue office where the returns are filed for the person (or estate) for whom you are acting. You should file this notice as soon as all of the necessary information (including the employer identification number) is available. It allows the Internal Revenue Service to mail to you the tax notices concerning the person (or estate) you represent. The notice remains in effect until you notify the appropriate Internal Revenue office that your relationship to the estate has terminated.

When you are relieved of your responsibilities as executor or administrator, you must advise the Internal Revenue office with which you filed the Form 56, referred to earlier, that the estate has either been terminated, or that your successor has been appointed. If the estate is terminated, you must furnish satisfactory evidence of the termination of the estate. Use Form 56 for the termination notice by checking the applicable box on the form and attaching the required evidence. If another has been appointed to succeed you as executor or administrator, you should give the name and address of your successor.

Discharge from personal liability. The executor or administrator may request a release from personal liability by making a written application to the Internal Revenue Service Center for a determination of the federal estate tax and a discharge from personal liability. Within 9 months after receipt of the application, the Service Center will notify the executor or administrator of the estate tax liability. If the executor or administrator makes the application before filing the return, the Service will make its notification within 9 months after the return is filed. Upon payment of this amount (or upon the payment of this amount less any amount for which payment has been extended) and upon furnishing a bond (if requested by the Service Center), the executor shall be discharged from personal liability for any deficiency in taxes thereafter found to be due. If no notice is received after the 9-month period, and the tax shown on the return has been paid, the executor or administrator is discharged from personal liability. In either case, the discharge is only for the personal liability of the executor. The executor or administrator is still liable for the payment of the federal estate tax in a fiduciary capacity out of assets included in the gross estate still in the executor's or administrator's possession.

Relief from personal liability for reliance on gift tax returns. If in good faith the executor relies on gift tax returns that are furnished by the Internal Revenue Service for determining adjusted taxable gifts made after 1976, then the executor is discharged from personal liability for any additional estate tax, which is attributable to ***adjusted taxable gifts*** that are:

1) Made more than 3 years before the decedent's death; and
2) Not shown on the gift tax returns.

Fiduciary other than executor. If the decedent was not a nonresident, a fiduciary other than the executor, like the trustee of a testamentary trust, can apply for a discharge from personal liability. The fiduciary should make written application to the Service Center for a determination of the amount of estate tax for which the fiduciary may be personally liable, and for a discharge from this liability. The fiduciary will be notified after the executor is discharged or after 6 months from the making of the application, whichever is later, of the amount of tax if any, for which the fiduciary is liable. Upon payment of this amount (other than the amount for which an extension of time to pay the tax has been granted), and upon furnishing a bond (if required), the fiduciary shall be discharged from personal liability for any such tax thereafter found to be due. This does not preclude, however, the assessment and collection of any deficiency in estate tax from the fiduciary out of the assets still possessed by the fiduciary.

Reimbursement out of estate. If the decedent died without a will, or if the will did not specify out of which bequests to satisfy the federal estate tax, state law will determine which assets included in the gross estate are liable. However, if the assets designated by state law are insufficient to pay the estate tax, the federal government may collect the taxes out of any asset or assets included in the gross estate. The beneficiaries of these assets are liable to the extent of the value of the assets received, valued on the decedent's date of death. In such a case a beneficiary may demand a reimbursement out of any part of the estate still undistributed, or a just and equitable contribution by other beneficiaries.

Liability of life insurance beneficiary. The executor may recover for the benefit of the estate a proportionate share of the federal estate tax from a beneficiary of life insurance proceeds on the life of the decedent and included in the gross estate, unless the decedent's will directs otherwise. However, if the surviving spouse is the beneficiary of the life insurance proceeds, only the amount in excess of the marital deduction may be recovered.

Liability of recipient of property over which decedent had power of appointment. The executor may also recover for the benefit of the estate a proportionate share of the federal estate tax from a person who receives property that was subject to a general power of appointment and that was included in the decedent's gross estate, unless the decedent's will directs otherwise, or, if the surviving spouse is that person, only amounts in excess of the marital deduction.

Assessment of estate tax. Generally, no tax may be assessed later than 3 years after the estate tax return is filed or is due, whichever is later. The period of assessment is 6 years if 25% or more of the value of the gross estate is not reported on the return. The period of assessment of taxes against recipients of property included in the gross estate is 4 years.

A tax lien attaches to all property included in the gross estate (except property used to pay certain administration expenses and claims) to cover the assessment. The lien will be considered to attach at the decedent's date of death and will not lapse until 10 years after that date unless payment is unenforceable by reason of lapse of time.

If the estate tax is not paid when due, all persons receiving this property are personally liable for the tax to the extent of the value of the property on the date of the decedent's death.

The executor or administrator may use Form Letter 626 and proof of payment, such as canceled checks or receipts, to establish that personal liability for the estate tax has been satisfied.

Special valuation for certain real property. Executors and administrators may elect the special estate valuation for the real property held by the decedent as a farm or in another type of closely held business as discussed earlier in Section 8(G), *Special Farm or Other Closely Held Business Real Property Valuation.*

A) Special Lien

In place of the executor's personal bond, an executor may elect a special lien in favor of the United States when the payment of taxes attributable to a closely held business interest (including a farm) is elected to be extended for the 10-year or 15-year period.

Under the new lien procedure, an executor can be discharged from personal liability during the extended payment period. No bond is required unless there is inadequate security for the amount of the unpaid principal and the interest payable over the payout period.

Under this lien procedure, the following requirements must be met:

1) All parties with an interest in the property designated that is subject to the lien must sign an agreement consenting to the creation of the lien;
2) A responsible person must be designated to be the agent for the beneficiaries of the estate and for the persons who consented to the lien for the purpose of dealing with the Internal Revenue Service on this lien and the deferred tax on the closely held business or farm.

This lien applies to real property and other assets designated in the lien agreement that can be expected to survive the period for payment of tax.

The value of property to be subject to the lien is the property's fair market value determined as of the due date for the estate tax return, reduced by other prior encumbrances, such as mortgages. If the executor or administrator has elected the special real property valuation for farms or other closely held businesses, the liens required by that provision also reduce the value of the property.

Additional lien property may be required if the value of the original property subject to the lien initially is less than, or later declines below, the sum of the unpaid deferred taxes and the required interest amount. If additional property or other security is not furnished within 90 days after notice and demand by the Internal Revenue Service, the failure is an event that will accelerate the payment of the tax installments.

The special lien replaces the regular estate tax lien. This new lien must be filed to be valid as against any purchaser, holder of the security interest, mechanic's lienor, or judgment lien creditor. However, once filed, it need not be refiled every 6 years, as is generally required of tax liens. This new lien arises when the executor is discharged from liability or, if earlier, when the notice of lien is filed. It continues until liability for the deferred amount of taxes is satisfied or becomes unenforceable by reason of lapse of time.

Even if the notice of the lien has been filed, the lien is inferior to, and not effective against:

1) Certain real property and special assessment tax liens;
2) Mechanic's liens for repairs or improvements to real property; or
3) Financing agreements securing loans for construction or improvement of real property, raising or harvesting of farm crops, or raising livestock or other animals, whether these security interests came into existence before or after the filing of the tax lien.

If the Internal Revenue Service files a notice that payment of the deferred amount has been accelerated, the tax liens take priority over subsequent mechanic's liens or real property construction or improvement financing agreements, but not real property tax or special assessment liens.

Election of lien. The election for this lien is exercised by applying to the Internal Revenue Service office where the estate tax return was filed at any time prior to payment of the full amount of estate tax and interest due. The application is a notice of election requesting the special lien and must be accompanied by the agreement to lien.

The rules for making the election based on the proposed regulations may be relied upon up to August 30, 1980. Any estate that made the election on or before August 30, 1980, may revoke their election. See *Revocation of election,* later in this discussion.

Agreement to lien. Generally, a special lien will not arise unless all parties having an interest in all property designated in the notice of election as property to which the lien attaches, sign an agreement consenting to the creation of the lien. (The property does not have to be property included in the decedent's estate.) The agreement is attached to the notice in which the special lien is elected. It must be in a form that is binding on all parties having any interest in the property and must contain the following information:

1) Decedent's name and taxpayer identification number as they appear on the estate tax return;
2) Amount of lien;
3) Fair market value of the property to be subject to the lien as of the date of the decedent's death and the date of the special lien election;
4) Amount, as of the date of the decedent's death and the date of the election, of all encumbrances on the property, including mortgages and other liens in favor of the United States;
5) Clear description of the property that is subject to the lien, and for property other than land, a statement of its estimated remaining useful life; and
6) Designation of an agent (including the agent's address) for the estate's beneficiaries and consenting parties to the lien for all dealings with the Internal Revenue Service on matters regarding the lien and the elections to pay the tax in installments.

An interest in property is any interest which as of the date of the election can be asserted under local law so as to affect the disposition by the estate of any property designated in the required agreement. Any person in being at the date of the election who has any such interest in the property, whether present or future, or vested or contingent, must enter the agreement. Included among such persons are owners of remainder and executory interests, the holders of general or special powers of appointment, beneficiaries of a gift over in default of exercise of any such power, co-tenants, joint tenants, and holders of other undivided interests when the decedent held a joint or undivided interest in the property, and trustees of trusts holding any interest in the property.

An heir who has the power under the local law to challenge (caveat) a will and thereby affect disposition of the property is not, however, considered to be a person with an interest in property solely by reason of that right. Likewise, creditors of an estate are not such persons solely by reason of their status as creditors.

If any person required to enter the agreement either desires that an agent act for him/her or cannot legally bind himself/herself due to infancy or other incompetency, a representative authorized under local law to bind the interested party in an agreement of this nature is permitted to sign the agreement on his behalf.

Partial substitution of bond for lien. If the amount of unpaid estate tax plus interest exceeds the value of property listed in the agreement, the Internal Revenue Service may condition the release from personal liability upon the executor's submitting an agreement listing additional property or furnishing an acceptable bond in the amount of such excess.

This lien is deemed to be a bond for purposes of determining an executor's release from personal liability. If an election has been made, the executor may not substitute a personal bond that relieves the executor from personal liability in lieu of the special lien. If a personal bond has been supplied that relieves the executor from personal liability, however, the executor may, by filing a proper notice of election and agreement, substitute a lien under these rules for any part or all of the personal bond.

If there is a special lien on any property with respect to an estate, that lien is in lieu of the lien provided by section 6324 on such property with respect to the same estate.

Revocation of election. Any estate that made the election on or before August 30, 1980, may revoke their election. To revoke an election, the executor must file a notice of revocation with the Internal Revenue Service

Center where the original estate tax return was filed. This notice must be filed on or before January 31, 1981, (or if earlier, the date on which the period of limitations for assessments expires). The notice must contain the decedent's name, date of death, and taxpayer identification number.

B) Basis—Property Acquired from a Decedent

Generally, the basis of property in the hands of a person acquiring the property from a decedent (or to whom the property passed from a decedent) is valued in one of the following manners:

1) The fair market value at the date of the decedent's death;
2) The fair market value determined on the alternate valuation date (discussed in Section 8(F)), if so elected by the executor; or
3) The special valuation for real property used in farming or other closely held business (discussed in Section 8(G)), if so elected.

Carryover basis of property. In 1976, rules were established concerning the carryover basis of property received from a decedent who died after 1976. Recent legislation, however, repealed these carryover-basis rules. Therefore, the basis of property acquired from a decedent who died after 1976 is computed under one of the three rules listed earlier.

C) Stock Redemptions to Pay Estate Taxes

Redemption of stock includible in a decedent's estate in order to pay death taxes is exempt from dividend treatment in certain circumstances. If the redemption qualifies, the redemption is treated as an exchange. Gain is treated as capital gain if the stock was held as a capital asset in the hands of the decedent at the time of the exchange.

In order to qualify for capital gains treatment, the value of a decedent's stock in a corporation whose stock is being redeemed must be more than 50% of the value of the ***adjusted gross estate;*** that is, the gross estate reduced by the sum of the losses, debts, and administrative expenses of the estate. If the estate includes stock of two or more corporations, then, for purposes of the 50% requirement, the stock of such corporations is treated as the stock of a single corporation if more than 75% in value of the outstanding stock of each corporation is included in determining the value of the decedent's gross estate.

This treatment is applicable to distributions in redemption made to pay death taxes after the date of the decedent's death and before the due date of the last installment. However, for any redemption made more than 4 years after the decedent's death, capital gains treatment is available only for distribution that is the lesser of:

1) The amount of the qualifying death taxes and funeral and administration expenses that are unpaid immediately before the distribution; or
2) The aggregate of these amounts that are paid within one year after the distribution.

The capital gains treatment applies to the distribution by a corporation only to the extent that the interest of a shareholder is reduced directly or through a binding obligation to contribute toward the payment of the estate's expenses or taxes.

Thus, this special capital gains treatment is available only when the business interest constitutes a substantial part of the estate of the decedent and the party whose shares are redeemed actually bears the burden of the estate taxes, state death taxes, or funeral and administration expenses equal to the amount of the redemption.

D) Internal Revenue Service Explanation of Valuation

If the Internal Revenue Service values any item of property for the purposes of the estate or gift tax or the generation-skipping tax, the executor, administrator, or donor may request that the Internal Revenue Service furnish a written statement explaining the valuation, including a copy of any expert appraisal made for the Service.

E) Federal Tax Lien Index

A federal tax lien generally takes priority over certain interests in property held by purchasers, holders of a security interest, mechanics lienors, and judgment lien creditors, but only if notice of the tax lien is appropriately filed.

Indexing required for certain real property acquired after November 6, 1978. For real property, the notice of tax lien meets the filing requirements if the fact of filing is entered and recorded in an index that meets the following two requirements.

1) Under the laws of the state in which the real property is located, a deed is valid against a purchaser of the property, who (at the time of purchase) has actual notice or knowledge of the existence of the deed, if the fact of filing of the deed has been entered and recorded in a public index at the place of filing in a manner that a reasonable inspection of the index will reveal the existence of the deed; and
2) There is maintained (at the applicable office within the state, county, or other governmental subdivision) an adequate system for the public indexing of federal tax liens.

Part II
The Gift Tax

This part explains the application of the tax law to gifts made after 1976.

1.
Nature of the Gift Tax

The federal gift tax is imposed on the gratuitous transfer of property. The person liable for the payment of the tax is the person making the gift (the donor). If the donor does not pay the gift tax, the person receiving the gift (the donee) may be called upon to pay the tax to the extent of the value of the property received by the donee.

2.
Persons Subject to the Federal Gift Tax

To determine whether a person is subject to a gift tax, you must first determine whether the person is a citizen or resident of the United States, or if the individual is not a citizen or resident, whether the property involved in the gift was situated within the United States.

A) Citizens or Residents of the United States

The federal gift tax is applied to all transfers by gift of property, wherever situated, by individuals who, at the time of the gift, were citizens or residents of the United States. The term ***United States*** includes only the 50 states and the District of Columbia. It does not include U.S. possessions or territories. For a U.S. citizen, the place of residence at the time of the gift is immaterial. A noncitizen is considered a U.S. resident if, at the time of the gift, the individual was domiciled in the United States. A person acquires a domicile by living in a place, even for a brief period of time, with no definite present intention of leaving permanently.

A gift by a corporation is considered a gift by its individual stockholders. A gift to a corporation generally is considered a gift to its individual stockholders, except in certain cases. When a gift is made to a charitable, public, political, or similar organization, it may be regarded as a gift to the organization as a single entity.

B) Nonresidents, Not Citizens

In the case of individuals who are neither citizens nor residents of the United States, the federal gift tax is applied only on gifts of property situated within the United States. Similar treatment is accorded a U.S. citizen residing in a U.S. possession at the time of the gift, if the individual acquired U.S. citizenship solely by reason of being a citizen of the possession, or by birth or residence in that possession. A gift of intangible personal property is not subject to the federal gift tax if it is made by a nonresident alien individual, except in the case of certain expatriate U.S. citizens. (See Section 16, *Gifts by Nonresidents, Not Citizens.*)

3.
The Gift Tax Return

Citizens or residents of the United States. If the total amount of taxable gifts during the first, second, or third calendar quarter of any calendar year is more than $25,000, Form 709, *United States Quarterly Gift Tax Return,* must be filed on or before the 15th day of the second month following the close of the calendar quarter in which the gifts were made, unless an extension of time for filing has been granted. The filing dates for such quarterly returns are May 15, August 15, and November 15.

If the total amount of taxable gifts during the fourth quarter of any calendar year is more than $25,000, Form 709 must be filed on or before the 15th day of the fourth month following the close of that calendar quarter. The filing date for the fourth quarter gift tax return is April 15, unless an extension of time for filing has been granted. See Section 4, *Extension of Time to File,* later in this publication.

If the cumulative total of taxable gifts made in the full calendar year is $25,000 or less, the gift does not have to be reported until the fourth quarter of the calendar year. In these cases, the return is required to be filed on or before April 15 of the following calendar year.

In the case of married individuals, Form 709-A may be filed if the total gifts to any one individual during the calendar year do not exceed $6,000. See the discussion later in this Section under *Form 709-A, United States Short Form Gift Tax Return.*

If the total amount of taxable gifts during a calendar quarter is $25,000 or less, the return must be filed on or before the required filing date of the first subsequent calendar quarter in the calendar year in which the sum of the taxable gifts made during such subsequent quarter (plus other taxable gifts made during the calendar year and for which no return has been filed) exceeds $25,000. This rule never extends the filing date for a return beyond April 15 of the following calendar year.

Example. Patricia Mack made a taxable gift of $23,000 in the first calendar quarter of 1979; she made a gift of $6,000 in the second quarter of 1979; and she made another gift of $10,000 in the third quarter.

The gift for the first quarter is less than $25,000; therefore, no return is required for that quarter.

Since the total gifts exceeded $25,000 in the second quarter of 1979, a gift tax return is due August 15, 1979. The gift in the third quarter does not have to be reported until April 15, 1980.

Nonresidents, not citizens. If the total amount of taxable gifts made during a calendar quarter exceeds $12,500, Form 709 must be filed in the same manner as that described for a citizen or resident of the United States. Similar filing requirements also apply if the total amount of taxable gifts made during a calendar quarter is $12,500 or less.

Gifts to charities. A gift tax return for qualified charitable transfers is not required on a quarterly basis. The donor, however, must report such transfers on a return for the fourth quarter of the calendar year, or for an earlier quarter if a gift tax return is required, for gifts other than for the charitable transfer. A qualified charitable transfer is one for which a deduction is allowable. See Section 14(A), *Charitable and Similar Gifts.*

Where filed. Form 709 should be filed with the Internal Revenue Service Center serving the state in which the individual who is making the gift has legal residence or a principal place of business. If the individual has no legal residence or principal place of business in a state served by an Internal Revenue Service Center, the return must be filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

Other documents. The return must be accompanied by certain documents pertaining to the determination of tax liability. These include copies of instruments executed in connection with transfers of property, statements by insurance companies on Form 712, *Life Insurance Statement,* in connection with every insurance policy listed on the return, and copies of appraisals of real property. If the return lists shares of stock in closely held corporations, documents must be submitted pertinent to their valuation, such as balance sheets, profit and loss statements for each of the 5 years preceding the valuation date, and statements of dividends paid during that period. Penalties are provided for willful failure to file a return on time and for willful attempt to evade or defeat payment of the tax.

Form 709-A, *United States Short Form Gift Tax Return.* (Available Approximately January 1981)

The federal gift tax applies if you made gifts of over $3,000 of present interests to any one person during the calendar year. If, however, you made gifts to third parties, you can "split" the gifts with your spouse and thereby double the amount excludable ($6,000, the total of the spouses' $3,000 exclusions). If your gifts to one or more persons totaled more than $3,000, but were nontaxable because no individual received more than $6,000, you may be able to use this shorter annual form instead of the longer quarterly Form 709.

Who may file. You can use Form 709-A if all of the following requirements are met:

1) You are a citizen or resident of the U.S., and were married during the entire calendar year to one individual who is a citizen or resident of the U.S.
2) Your only gifts to a third party consisted entirely of present interests in tangible personal property, cash, or stocks and bonds listed on a stock exchange.
3) Your total gifts to each third-party donee are not more than $6,000 for the calendar year.
4) You did not make gifts of more than $3,000 to your spouse.
5) Your spouse did not make any gifts during the calendar year to any of the donees listed on this form.
6) Your spouse agrees to split with you all of the gifts you made during the calendar year.

Note: Gifts include transfers of property where no money changes hands and also transfers where some payment was made, but the payment made was less than the value of the item transferred.

When to file. Form 709–A is a calendar year return to be filed on or before April 15 of the calendar year following the year when the nontaxable split gifts were made, unless an extension of time to file has been granted.

The back of Form 709–A contains specific instructions for filing that form.

4. Extension of Time to File

Applications for extensions of time for filing gift tax returns (not to exceed 6 months) may be filed with the District Director or Service Center for the donor's area. The reason for the delay must be fully explained. An extension of time to file does not extend the time for paying the tax.

An extension of time granted for filing an income tax return for any tax year that is a calendar year will automatically extend the time for filing the gift tax return for the ***fourth quarter*** of that tax year.

5. Payment of the Tax

The tax shown on the gift tax return is to be paid by the person required to file the return at the time and place fixed for filing.

6. Extension of Time to Pay the Tax

At the request of the donor, a reasonable extension of time, not to exceed 6 months unless the donor is abroad, may be granted by the Service Center for the payment of the tax shown on the return.

If there is a deficiency and the recipient is required to pay the gift tax, the deficiency usually must be paid within 18 months. In an exceptional situation another 12 months may be granted.

7. Interest on Tax Underpaid or Postponed

Interest at the adjusted rate(s) must be paid on any amount of tax that is not paid on or before the last date prescribed for the payment of the tax.

The interest rates on underpaid taxes or taxes for which the time for payment has been extended will be periodically adjusted to conform to the prime interest rate charged by banks. Contact the Internal Revenue service for the current rate.

An additional penalty of one-half percent per month of the unpaid balance, up to a maximum of 25%, will also be imposed, unless the failure to pay was for reasonable cause.

8. Gifts in General

The gift tax applies to any gift of real or personal property, whether direct or indirect, whether tangible or intangible, and whether given in trust or otherwise. In other words, all transactions in which property or property interests are gratuitously transferred to another constitute gifts subject to tax.

However, transfers of money or other property to a qualified political organization (including a newsletter fund) for use by the organization are not subject to the gift tax. Special rules for the types of property or property interests given by nonresidents, not citizens are discussed in Section 16, *Gifts by Nonresidents, Not Citizens.*

The tax does not apply to transfers made for valuable consideration unless the value of the gift exceeds the consideration received. In that case, the tax is imposed only on the value of the excess. However, if a bona fide transfer, sale, or exchange is made at arm's length in the ordinary course of business, the transaction will be assumed to be for consideration and not gratuitous. A consideration that is not reducible to a value in money or money's worth, such as love and affection, or a promise of marriage, is to be wholly disregarded and considered totally gratuitous.

A relinquishment (or promised relinquishment) of dower or curtesy, or of other marital rights in a spouse's property or estate, is not considered to any extent a consideration "in money or money's worth." If property is transferred in exchange for the release of such rights, the property is a gift for gift tax purposes. However, see Section 10(D), *Certain Property Settlements,* for an explanation of transfers of property in the event of an actual divorce and a written agreement.

If a gift is made on the express or implied condition that the donee pay the gift tax, the payment of this tax may be deducted from the value of the gift made as partial consideration for the gift. It should be noted that such an agreement does not release the donor from the principal liability of paying the gift tax, if in fact the tax is not paid. The payment of gift taxes by a donee causes an interrelated computation known as a ***net gift computation.*** This computation is explained in Publication 904, *Computing the Interrelated Charitable, Marital, and Orphans' Deductions, and Net Gifts,* which may be obtained from your local Internal Revenue Service office.

In view of the many ways that a gift can be made, it is possible to list only a few examples of transfers that come within the scope of the taxing statute.

Example 1. An individual creates a trust under the terms of which a child is to get income for life and a grandchild the remainder at the child's death. Gifts of the income to the child and of the remainder to the grandchild result from the transaction.

Example 2. An individual, with personal funds, purchases real property and has title conveyed to the individual and the individual's brother as joint tenants with right of survivorship. A gift has been made to the brother.

Example 3. An individual, with his own funds, creates a joint bank account for himself and his brother. There is a gift when the brother draws money out of the account for his own benefit. If both had contributed money to the account, there would be a gift by one to the other only to the extent that the amount withdrawn by the other person exceeds his own contribution.

Example 4. An individual, with his own funds, purchases a U.S. savings bond registered as payable to himself and his wife. There is a gift to his wife when she surrenders the bond for cash for her own benefit.

Certain types of transfers are subject to special taxation rules. They are discussed in Section 10, *Particular Types of Gifts.*

9. Cessation of Donor's Dominion and Control

The gift tax is not imposed upon the receipt of gift property, but rather upon the donor's act of making the transfer. This applies whether the gift property is tangible or intangible, real or personal.

A gift is complete if a donor has ***parted with dominion and control*** over the transferred property or property interest, leaving the donor without the power to change its disposition, whether for the benefit of the donor or for the benefit of others.

A promise to make a gift becomes taxable in the year in which the obligation becomes binding and not when the discharging payments are made. As a result, if one promises to transfer property in the future, the gift be-

comes taxable as of the first date on which it is possible to determine that the transfer must be made and that it will be of a determinable amount.

Example 1. If a donor creates a trust under the terms of which the donor can revoke the transfer and revest title in the donor's name, the transfer is an incomplete gift. The same would be true if the donor reserved the power to alter the instrument, enabling him or her to name new beneficiaries or change the interests of the beneficiaries. The gift would, in either case, become complete at such time as the donor renounces the power, or the right to exercise it ceases, because of the occurrence of some event or contingency or the fulfillment of some condition other than the death of the donor. Despite the reservation by the donor of these powers, the gift would be considered complete if the powers could be exercised only with the consent of a person having a substantial adverse interest.

Example 2. William Cedar, the donor, creates a trust giving income for life to his wife and providing that, at her death, the corpus is to be distributed to his son. William reserves the right to revoke the transfer but only with the consent of his son, in which event the corpus would revest in William. The gift is considered complete in its entirety.

Example 3. If a donor delivers a properly endorsed stock certificate to the donee or the donee's agent, the gift is completed, for gift tax purposes, on the date of delivery. If a donor delivers the certificate to a bank or broker as the donor's agent, or to the issuing corporation or its transfer agent, for transfer in the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.

Example 4. If a donor delivers his own check or note to another as a gift, the gift is not complete, for gift tax purposes, until the check or note is paid or is transferred for value to a third person.

10. Particular Types of Gifts

There are particular types of gifts for which the gift tax statute provides special rules. These rules are discussed in this section.

A) Powers of Appointment

The exercise or complete release of a general power of appointment is treated as a gift unless the exercise or release was for adequate consideration. There are different rules for the treatment of a power of appointment if the power was created before October 22, 1942. These are discussed later.

A power of appointment is a power to determine who shall own or enjoy, presently or in the future, the property subject to the power. It must be created by another and does not include a power created by the possessor, or retained by the possessor when the possessor transfers property owned by the possessor. The term ***power of appointment*** includes all powers that are, in substance and effect, powers of appointment regardless of the terminology used in a particular instrument and regardless of local property law.

Some powers do not constitute a power of appointment. A power to amend only administrative provisions of a trust that do not substantially affect the beneficial enjoyment of the trust property or income would not be considered a power of appointment. Likewise, a simple power to manage, invest, or control assets, or to allocate receipts and disbursements, when exercised only in a fiduciary capacity, would not be considered a power of appointment.

Nongeneral, or special, powers of appointment are not general powers if, by their terms, they are exercisable only for the benefit of one or more persons or classes which do not include the possessors of the power, their creditors, their estates, or the creditors of their estates, or expressly are not exercisable in favor of their creditors, their estates, or creditors of their estates.

An individual who has both a lifetime income interest in a trust as well as a special (or nongeneral) power to appoint the underlying property to other persons, possesses two separate rights. If the individual exercises the special power during life, a taxable gift results, since the individual, by exercising that power, also gave up the income interest. The value of such gift is the amount of the income interest subject to the individual's power at the time of the transfer. The release of the special power itself does not result in a taxable gift.

General powers of appointment are those in which the possessors of the powers can appoint the property subject to the power to themselves, their creditors, their estates or their estate's creditors. They include the unlimited power to consume, invade, or appropriate either income or corpus, or both, for the benefit of the holder of the power.

Example. If Bob Smith was given the power to appoint the corpus of a trust to any of 6 persons not including himself, but also was given the power to invade the corpus for any reason for his own benefit, he would have a general power of appointment and the exercise or release of this power results in a gift. On the other hand, a power given to Bob to consume or invade for his own benefit, limited by an ascertainable standard relating to his health, education, support, or maintenance, would not be considered a general power of appointment, and the exercise or release of such a power would not result in a gift.

A power to use property for the ***possessor's comfort, welfare, or happiness*** is ***not*** considered an ascertainable standard.

Joint interests. If a power of appointment is exercisable by the possessor, but only with the consent or joinder of the creator of the power, or a person having a substantial adverse interest in the property subject to the power, the possessor is ***not*** considered to hold a general power of appointment. For this purpose, a trustee administering a trust in a fiduciary capacity does not, by that fact alone, have an adverse interest in the trust.

Exercise or release. If the possessor of a general power of appointment exercises or releases the power during any calendar quarter, the possessor will have made a gift during that calendar quarter. A release of a power need not be formal in character.

Example. The failure to exercise a general power of appointment within a specified time, so that the power lapses, constitutes a release of the power. However, the lapse is treated as a release only to the extent that the value of the property that could have been appointed by the exercise of the lapsed power exceeds the greater of either $5,000, or 5% of the total value of the property out of which the appointment could have been satisfied.

Disclaimer. In contrast to a release of a power by the possessor of the power, the disclaimer or renunciation of a general power of appointment by the donee of the power does not result in a gift by the disclaiming donee. If the power was created in the disclaiming donee before January 1, 1977, the disclaimer must not only meet the requirements of local law, but also the additional requirements described in Treasury regulations.

A disclaimer of a power of appointment, created in the disclaiming donee after 1976, need only meet federal requirements in order to be a qualified disclaimer for federal tax purposes.

In general, a disclaimer is a complete and unqualified refusal to accept the power of appointment. There can be no disclaimer of a power after it has once been accepted.

The exercise of a general power of appointment created before October 22, 1942, will also result in a gift. However, the release or lapse of such a power does not result in a gift. Also, a power created before October 22, 1942, that is only exercisable by the possessor in conjunction with another person, regardless of adverse interest, is not treated as a general power of appointment.

A power of appointment created by will generally is considered as created on the date of the creator's death. However, a power of appointment created by a will executed before October 22, 1942, is considered as created on or before that date if the creator died before July 1, 1949, without having republished the will by codicil or otherwise after October 21, 1942. A power of appointment created by an inter vivos instrument is considered as created on the date the instrument takes effect. Such power is not considered as created at some future date merely because it is not exercisable immediately, or because it is revocable, or because the identity of its holders is not ascertainable until after the date the instrument takes effect.

However, if the holder of a power exercises it by creating a second power, the second power is considered as created at the time of the exercise of the first.

B) Qualified Disclaimers

For the purpose of the estate, gift, and generation-skipping transfer taxes, if a recipient makes a qualified disclaimer with respect to any interest in property, the property will be treated as if it had never been transferred to the recipient. Accordingly, the disclaimant is not regarded as making a gift to the person taking by reason of the qualified disclaimer.

Local law affects the characterization of a disclaimer as a ***qualified disclaimer.*** If a disclaimer, under local law, does not allow the person disclaiming the property to rid himself/herself of the property's ownership, and transfer its ownership to another person, then it is not a ***qualified disclaimer.*** However, a person disclaiming property is not considered as accepting property, merely because under local law title to the property transfers to the person disclaiming the property upon the death of a decedent.

Requirements. To be a qualified disclaimer, a refusal to accept an interest in property must meet the following conditions:

1) The refusal must be in writing;
2) The written refusal must be received by the transferor of the interest, the legal representative of the transferor, or the holder of the legal title to the property to which the interest relates no later than the date which is 9 months after the later of the day on which the transfer creating the interest in the disclaimant is made, or the day on which the disclaimant attains age 21;
3) The disclaimant must not have accepted the interest or any of its benefits;
4) As a result of the refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either:
   a) To the spouse of the decedent, or
   b) To a person other than the person making the disclaimer; and
5) The refusal is irrevocable and unqualified.

Determination of 9-month period. The 9-month period for making a disclaimer generally is to be determined with reference to each taxable transfer. For inter vivos transfers it is the date the transfer is a completed transfer for gift tax purposes. For testamentary transfers it is the date of the decedent's death.

For example, in the case of a general power of appointment, when the other requirements are satisfied, the person who would be the holder of the power will have a 9-month period after the creation of the power in which to disclaim; the person to whom the property would pass by exercise of the power would have a 9-month period, after a taxable exercise by the holder of the power, in which to disclaim. When a lifetime transfer is included in the transferor's gross estate because the transferor had retained an interest in the property, the person who received the interests in the property during the lifetime of the grantor and a person who would receive an interest in the property on or after the grantor's death would have a 9-month period after the original transfer in which to disclaim if the other requirements are satisfied.

A qualified disclaimer may be made with respect to an undivided portion of an interest. A power with respect to property shall be treated as an interest in that property.

C) Tenancies by the Entirety

Joint property interests are interests in real or personal property held by 2 or more persons with (or without) the right of survivorship. To the extent that one joint tenant furnished more consideration than another joint tenant in the creation of a joint tenancy, a gift may result.

In order for a gift to result, the transfer must be completed. State law determines if a transfer is a completed gift.

Tenancies by the entirety in real property. A tenancy by the entirety is essentially a joint interest in real property between husband and wife with the right of survivorship or a tenancy that gives them similar rights, regardless of local terminology.

The contribution made by a husband or wife in the creation of a tenancy by the entirety may constitute a gift either at the time of the contribution or at the time of the termination of the tenancy. The contribution made by a husband or wife in the creation of a tenancy by the entirety in real property is ***not considered a gift in that calendar quarter,*** unless the contributing spouse elects to treat the transaction as a gift in that quarter.

Creation by election. In order to make the election, a gift tax return must be filed for the quarter in which the transaction occurred, even though the value of the gift does not exceed $3,000.

If this election is made, with respect to any property, the interest of each spouse is treated as one-half of their joint interest.

The election applies to each addition to the value of the tenancy and the interest of each spouse is treated as one-half of the value of the total joint interest regardless of the amount contributed.

If the election is not made, no gift will result at the time the tenancy is created. However, a gift results upon the termination of such a tenancy, other than by the death of the spouse, if the proceeds received by one of them on termination of the tenancy are larger than the proceeds allocable to the consideration furnished (including additions) by that spouse to the tenancy.

When a completed gift occurs, either at the creation or termination of the tenancy by the entirety, the gift tax marital deduction is applicable. The gift tax marital deduction is discussed later under Section 14(B), *Gifts to Spouse (Marital Deduction).*

Tenancies by entirety in personal property. The retained interest of each spouse is treated as one-half of their joint interest in the case of:

1) A creation (either by one spouse alone or by both spouses) of a joint interest of a husband and wife in personal property with right of survivorship; or
2) Any additions to the value of the personal property, such as improvements and reductions in indebtedness on the property.

Therefore, acturial computations are unnecessary in determining the amount of gift for the creation of a joint tenancy between husband and wife in personal property. However, there is an exception to the rule.

Exception. Actuarial computations are required for any joint interest in personal property, if the fair market value of the interest or of the property (determined as if each spouse had a right to sever) cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. For example, the amount of a gift involving a joint and survivor annuity would require an actuarial computation.

Qualified joint interests. Interests created by a husband and wife after 1976 may be qualified joint interests. If they do qualify, they are accorded special treatment for estate tax purposes. This is discussed in detail under Section 7(G), *Joint Interests,* in Part I.

D) Certain Property Settlements

Transfers of property or property interests made under the terms of a written agreement between spouses in settlement of their marital or property rights are deemed to be for adequate consideration in money or money's worth and, therefore, are exempt from the gift tax (whether or not the agreement is approved by a divorce decree), if the spouses obtain a final decree of divorce within 2 years after entering into the agreement. Transfers to provide a reasonable allowance for the support of minor children (including legally adopted children) of a marriage are not subject to the gift tax if made under an agreement that satisfies these requirements.

A legal obligation of support is reducible to a value in money and may be surrendered as adequate consideration in exchange for property. A transfer in settlement of dower or curtesy inheritance rights, on the other hand, is not reducible to money, and results in a gift. Therefore, the transfer of property under a property settlement agreement incident to a legal separation results in a gift ***only*** to the extent that the value of the transferred property exceeds the value of any support rights surrendered.

Voluntary increases in support payments after a final decree of divorce are subject to the gift tax if, under state laws, the court has no

authority to modify the decree as it pertains to the payments. The value of the gift is the amount by which each payment exceeds the amount specified in the original written agreement between the spouses.

If a husband and wife enter into a written property settlement, and a final decree of divorce is not granted on or before the due date for filing a gift tax return for the calendar quarter in which the settlement becomes effective, the property transfer must be disclosed by the transferor on a gift tax return for that calendar quarter. A copy of the settlement agreement must be attached to the return, and a certified copy of the final divorce decree must be furnished the Internal Revenue office where the gift tax return was filed not later than 60 days after the divorce is granted. Pending receipt of evidence that the final decree of divorce has been granted (but in no event for more than 2 years from the effective date of the settlement), the transfer will tentatively be treated as made for an adequate consideration in money or money's worth.

Transfer in trust incident to divorce with spouse's right to support surrendered. The following example with the three situations illustrate the gift tax consequences of an individual's transfer of property to a trust, under an agreement in contemplation of divorce and in exchange for the spouse's surrender of support rights. Under the three situations, the trust income of the trust is payable for the spouse's life:

1) To the spouse with the remainder payable to the children of the donor and the spouse;
2) Partially to the spouse and partially to a child of the donor with the remainder payable to the children of the donor and the spouse; and
3) To the spouse with the remainder payable to the donor's brother.

Example. John and Mary Brown entered into a written agreement in contemplation of a divorce. Except as specified in each situation, each agreement contained a provision that, in exchange for Mary's surrender of the right to support, John would transfer $100,000 to a trust upon the issuance of a divorce decree.

At the time of the agreement, John and Mary had two adult children. In each case, the divorce occurred more than 2 years after the agreement was signed, and the divorce decree was issued by a court that had no power to alter or invalidate the agreement.

Situation 1. Under the terms of the trust, the income is payable to Mary for life, and at Mary's death the principal is payable to the adult children of John and Mary. Since their children are adults, John and Mary have no legal obligation to support them. When John made the transfer to the trust, the present value of Mary's right of support was $50,000. The present value of the right to trust income for Mary's life is $60,000 as of the transfer date. The present value of the remainder is $40,000.

Gift tax consequences. Since the value of the trust income interest transferred by John exceeds the value of Mary's support rights surrendered by her, John's gifts for federal gift tax purposes follow.

1) $10,000 to Mary (the excess of the value of Mary's income interest ($60,000) over her support rights ($50,000); and
2) $40,000 to John and Mary's children (the full value of the remainder interest).

Situation 2. Under the terms of the trust, one-third of the trust income is payable to one of John and Mary's adult children, and two-thirds of the income is payable to Mary. At Mary's death, all income payments stop and the trust principal is paid to both of John and Mary's adult children. John and Mary have no legal obligation to support their adult children. The present value of the adult child's right to trust income is $20,000 and the present value of Mary's right is $40,000. The present value of Mary's right of support is $50,000.

In negotiating the settlement agreement, John agreed to provide the one child with the one-third income interest after Mary asserted a preference to receive an income interest of lesser value than Mary might otherwise demand, in view of Mary's support rights, to secure the income payments to their child.

Gift tax consequences. Mary bargained for a reduced income interest to secure an income interest in the trust for the child. Thus, the excess ($10,000) of the value of Mary's support rights ($50,000) over Mary's income interest ($40,000) is excludable from the value of the child's income interest ($20,000) as consideration in money or money's worth. The amount of John's gift to the child is the excess of the income interest transferred to the child over the value of the consideration received by John, or $10,000.

Since Mary transferred the excess value ($10,000) of her support rights to secure the income interest to the child, Mary has made a taxable gift to the child of $10,000.

The gift tax is also applicable to the full value of the remainder interest ($40,000) transferred by John to the child.

Situation 3. Under the terms of the trust, after Mary's death (to whom all income is payable), the trust will terminate, and the remaining trust principal is payable to John's brother, Fred.

The present value of the remainder interest is $40,000. The value of Mary's surrendered right to support is $70,000, thus exceeding the value of Mary's right to trust income ($60,000) by $10,000.

Mary neither suggested nor was concerned with naming the person who would receive the remainder of the trust principal after her death. Mary's main concern was to avoid any litigation or other delays; thus, she settled for a monthly payment that was smaller than the amount she would have received if she had demanded and been paid the full value of the support she was entitled to.

Gift tax consequences. The transfer of the income interest to Mary was adequately met by valuable consideration; thus, no gift was paid to Mary.

However, the amount of the gift of the remainder interest from John to his brother Fred is its full present value of $40,000 on the date of the gift.

Although John obtained a release by Mary of support rights that exceeded the income interest transferred to her, the excess value was not paid to secure the transfer of the remaining interest to Fred. Thus, no amount is excludable as consideration in money or money's worth from the value of the remainder interest transferred by John to his brother.

However, the value of the support rights ($70,000) Mary surrendered to John exceeded the income ($60,000) transferred by John to Mary by $10,000. Her motives for releasing the excess value the support rights (to void litigation and delay) are not consideration for purposes of the gift tax. Thus, Mary has made a taxable gift to John equal to $10,000.

E) Survivor Annuities

A gift generally will result when an employee who has an unqualified right to an annuity elects to receive a lesser amount so that at the employee's death a survivor annuity will be paid to the employee's designated beneficiary. The gift is made in the calendar quarter in which the employee gives up the power to deprive the beneficiary of the survivor annuity by making the election irrevocable.

However, if an election or option and the annuity are part of a ***qualified plan*** or an ***individual retirement arrangement,*** the election, to some extent, may not be subject to the gift tax. A ***qualified plan*** is a stock bonus, pension, or profit-sharing plan that meets a number of conditions specified by law. An employee should ask the employer if the plan is qualified. If the plan is qualified, only that part of the annuity that is attributable to the employee's contributions to the plan is subject to the gift tax when the election or option is exercised. The portion of the annuity attributable to the employer's contributions to the plan is not subject to the gift tax. Contributions by, or on behalf of, a self-employed person under a qualified retirement plan are considered ***contributions by an employer*** to the extent that the contributions were deductible for income tax purposes.

No exclusion from the gift tax is allowable to the extent that the employee's interest in a qualified noncontributory profit-sharing plan has been made available to the employee before the exercise of the election or option, without any significant penalty or restriction on the exercise of his or her right to obtain full possession of that interest.

The value of survivor annuity benefits either elected or automatically provided to the retiree's spouse under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan is excluded from the gift tax.

Community property. In most community property states, a taxpayer's spouse is considered to have a one-half interest in the earnings and accumulated benefits of the taxpayer. Therefore, the surviving spouse would be considered as having made a gift of one-half of any benefits as a result of a deceased spouse's death when these benefits are payable to other beneficiaries.

However, the value of the surviving spouse's interest in the deceased spouse's benefits is not considered a gift by the surviving spouse to other beneficiaries to the extent:

1) The interest is attributable to employer contributions (see the preceding discussion); and
2) The interest arose solely as an interest in community income under a state's community property laws.

11. Valuation of Property

The value of a gift is the ***fair market value*** of the property given on the date the gift is made. There is no alternate valuation date for the federal gift tax as there is for the federal estate tax.

The ***fair market value*** is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of all relevant facts. Fair market value may not be determined by a forced sale price, nor by the sale price of the item in a market other than that in which that item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

Thus, in the case of an item that is generally sold at retail, the fair market value is the price at which the item or a comparable item would be sold.

Example. An automobile generally is retailed so its fair market value would be its retail value. The price a used car dealer would pay may not be used. If tangible personal property is sold as the result of an advertisement in the classified section of a newspaper, and the property is of a type often sold by such means, or the property is sold at a public auction, the selling price will be presumed to be the retail sales price of the item at the time of the sale. This retail sales price also will be presumed to be the retail sales price of the item on the date of the gift if the sale is made within a reasonable period following the gift and there is no substantial change in market conditions or other circumstances affecting the value of similar items between the time of the sale and the date of the gift.

Gift tax paid by donee. If a gift is made on the express or implied condition that the donee pay the gift tax, the amount of this tax may be deducted from the value of the gift made as partial consideration for the gift. It should be noted that such an agreement does not release the donor from the principal liability of paying the gift tax, if in fact the tax is not paid.

When a gift is made jointly (split) by a husband and wife who are in different gift tax brackets with the condition that the gift tax is to be paid by the donee or out of the property itself, a special formula is used to compute the gift tax that is deducted in order to value the gift. This formula may be found in Publication 904.

The payment of gift taxes by a donee causes an interrelated computation known as a net gift computation. This computation is explained in Publication 904, *Computing the Interrelated Charitable, Marital, and Orphans' Deductions and Net Gifts,* which may be obtained from the Internal Revenue Service.

Special rules. There are special rules for determining the fair market value of particular types of property, such as stocks and bonds, shares of mutual funds, interests in a business, annuities, life insurance, life estates, terms for years, remainders, and reversions. These rules are generally the same as those for the determination of fair market value for federal estate tax purposes and are discussed in detail in Section 8, *Valuation,* of Part I.

For a complete discussion of valuation, obtain Publication 561, *Determining the Value of Donated Property.*

12. Exclusions From Gifts

A) General

The first $3,000 of gifts made to any one person during any calendar year (except gifts of future interests in property) is excluded in determining the total amount of gifts for the calendar quarter. This $3,000 annual exclusion is applied to all gifts of a present interest made during the calendar year in the order in which they were made until the $3,000 exclusion per person is exhausted. For a gift in trust, each beneficiary of the trust is treated as a separate person for purposes of the $3,000 exclusion. However, the $3,000 exclusion is not available for gifts of a future interest, such as a remainder interest in a trust. The entire value of such a gift must be included in the total amount of gifts for the calendar quarter in which the gift was made.

B) Future Interests

Future interests is a legal term that includes reversions, remainders, and other interests or estates, whether vested or contingent, that are to commence in use, possession, or enjoyment at some future date. On the other hand, an unrestricted right to the immediate use, possession, or enjoyment of property or the income from the property is a present interest in property.

Example 1. Fred Jones created a trust under the terms of which his son was to get for life the entire income from the property, with the remainder going to Fred's grandson at the death of his son. There is a gift of a present interest to the son and of a future interest to the grandson. However, if Fred directed the trustees to pursue an investment policy that results in future increases in the value of the trust, rather than current income, his son would not have a present interest, and a $3,000 annual exclusion would not be allowed for Fred's gift to his son.

Proof of gift value. The donor who claims the annual exclusion has the burden of proving the value of the amount of the gift that is claimed to be a present interest. Generally, the gift tax exclusion is not allowable unless:

1) The number of eventual donees is ascertainable; or
2) The interest of each beneficiary is able to be valued.

However, the allowance of the exclusion is determined by the facts in each case.

Gift to corporation. A gift to a corporation is a gift of a future interest to its stockholders, and does not qualify for the $3,000 exclusion. But such a gift qualifies for the marital deduction in proportion to the interest of the donor's spouse in the corporation.

Exceptions to the future interest rule are discussed in *C) Transfers for the Benefit of a Minor* and *D) Individual Retirement Arrangements for Spouse.*

C) Transfers for the Benefit of a Minor

A transfer for the benefit of a person who has not attained age 21 on the date of the gift may be considered a gift of a present interest even though the minor is not given the unrestricted right to the immediate use, possession, or enjoyment of the property or the income from it. Therefore, the $3,000 annual exclusion is available for such transfers.

Conditions. For the gift to the minor to be considered a present interest the following conditions must be satisfied:

1) Both the property and its income may be expended by, or for the benefit of, the minor before attaining age 21;
2) Any portion of the property or its income not disposed of by the minor's 21st birthday must pass to the minor at that time; and
3) If the minor dies before attaining age 21, the property and its income will be payable either to the minor's estate or to whomever the minor may appoint under a general power of appointment.

A transfer will qualify for this exception even though a trustee is given discretionary power as to when and how much of the property and its income will be distributed to, or for the benefit of, a minor before the minor's 21st birthday. However, if the terms of the trust impose any substantial restrictions on the trustee's exercise of such discretion, the trust will not qualify.

Example. If the trust provided that the trustee could distribute to the minor as much of the property or income as the trustee deemed necessary, but only if the minor's needs could not be met by the minor's parents or from the minor's own resources, the trust would not qualify as a present interest, because a substantial restriction was imposed on the trustee's power to use the property for the minor's benefit.

Trust instrument. The trust instrument can provide for the continuation of the trust beyond the beneficiary's 21st birthday, as long as the minor has a right upon reaching age 21 either to compel immediate distribution of the trust corpus by giving written notice to the trustee, or to permit the trust to continue by its own terms. The terms of the trust also may provide a taker in default if the minor fails to exercise a general power of appointment should the minor die before age 21.

Requirements partly satisfied. A gift to a minor that does not satisfy all the requirements to be a present interest may still qualify in part.

Example. A transfer of property in trust with income to be distributed annually to the minor, and corpus to be distributed upon the attainment of age 25, is a gift of a present interest of the income and a gift of a future interest of the corpus.

A gift of trust income to a minor also will qualify for this exception even though the minor is given no interest in the corpus and the income may be accumulated until the minor's 21st birthday, provided the requirements just discussed are met.

D) Individual Retirement Arrangements for Spouse

A payment by an individual to an individual retirement arrangement for the benefit of a spouse is not considered a gift of a future interest to the extent that the payment is an allowable income tax deduction. Thus, the deductible portion of the payment qualifies for the $3,000 annual exclusion. The payments may be made to an individual retirement account, for an individual retirement annuity, or for a retirement bond.

13. Gift by Husband or Wife to Third Party (Gift Splitting)

A gift made by a person to someone other than a spouse may be considered, for federal gift tax purposes, as having been made one-half by each spouse. Therefore, spouses may elect ***to split the gift*** made to a third party and thereby get the benefit of using the lower gift tax rate brackets. In addition, by ***splitting the gift*** the annual exclusion and the unified credit (see Section 14(B)) could be doubled.

To split the gift the spouses must be legally married to each other at the time of the gift. If they divorce each other later in the calendar quarter, they still may split the gift so long as neither marries anyone else during that quarter.

They both must signify on their separate gift tax returns their consent to have all gifts made in that calendar quarter split between them. In addition, both must be citizens or residents of the United States on the date of the gift and one spouse may not create a general power of appointment in the other spouse over the property transferred.

Generally, in community property states the election is not available to spouses who make gifts of community property because both spouses are already considered to own the gift property equally.

A gift from one spouse to the other spouse cannot be split between them, but may qualify for the martial deduction as discussed in Section 14(B), *Gifts to Spouse (Marital Deduction).*

If either spouse is a nonresident, not a citizen, they may not elect to split a gift made to a third party.

14. Deductions and Credits

A) Charitable and Similar Gifts

There may be deducted from the total amount of gifts made during the calendar quarter (or previous quarters if not reported previously in that year) all gifts included in the total that were made to or for the use of:

1) The United States, any state, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes;
2) Any corporation, trust, community chest fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment) and the prevention of cruelty to children or animals, as long as no part of the net earnings inures to the benefit of any private individual and no substantial activity is undertaken to carry on propaganda, or otherwise attempt to influence legislation or participate in any political campaign on behalf of any candidate for public office;
3) A fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes including the encouragement of art, and the prevention of cruelty to children or animals; or
4) Any veterans' organization organized in the United States or any of its auxiliary departments or local chapters or posts, as long as no part of the net earnings inures to the benefit of any private individual.

Transfers subject to a condition or power. If, at the date of the gift, a transfer to a qualified charity is contingent upon some act or occurrence, no deduction is allowable unless the possibility that the transfer will not become effective is so remote that the contingency is negligible.

If the donee or the trustee has the power to divert the property or fund, in whole or in part, for a use or purpose that is not deductible, only the portion of the property or fund not subject to this power is deductible.

Partial interests. If a donor transfers an interest in property for both charitable and noncharitable purposes, no charitable deduction is allowed unless the interest is deductible under (1) through (6) that follow.

1) ***An undivided portion of the donor's entire interest.*** If the donor transferred for a charitable purpose an undivided interest, ***not in trust,*** of the donor's entire interest in property, the value of the interest is a deductible charitable contribution. An undivided portion of the donor's entire interest in property must consist of a fraction, or a percentage, of each and every interest or right owned by the donor in the property, and it must extend over the entire term of the donor's interest in that property or in other property into which the donated property is converted.
2) ***Remainder interest in a personal residence.*** If the donor transferred for a charitable purpose the remainder interest, ***not in trust,*** in the donor's personal residence, the value of the interest is a deductible charitable contribution.

The term ***personal residence*** means any property used by the donor as a residence, such as a vacation home, even though it is not used as a principal residence. The term also includes stock owned by the donor as a tenant-stockholder in a cooperative housing corporation, if the dwelling the donor was entitled to occupy was used by the donor as a personal residence. A residence does not include household furnishings that are not fixtures. The charitable remainder interest must be in the residence itself and not in the proceeds to be derived from the sale of the residence.

3) ***Remainder interest in a farm.*** If the donor transferred the remainder interest, ***not in trust,*** in a farm to a qualified charity, the value of that interest is deductible.

A farm for this purpose means ***any*** land used by the donor, or by a tenant of the donor, for the production of crops, fruits, or other agricultural products, or for the sustenance of livestock. A farm includes improvements thereon.

4) ***Transfers of partial interests for conservation purposes.*** The following interests in property are deductible as a charitable contribution if they are made to a charitable organization exclusively for conservation purposes:

a) A lease on, option to purchase, or easement with respect to real property granted in perpetuity, if made after June 13, 1977, and before June 14, 1981; or

b) A remainder interest in real property, if made after June 13, 1976, and before June 14, 1981.

Conservation, for these purposes, is the preservation of land areas for public outdoor recreation or education, or scenic enjoyment; the preservation of historically important land areas or structures; or the protection of natural environmental systems.

5) ***Remainder interests, charitable remainder trusts, and pooled-income funds.*** A charitable deduction will be allowed for the transfer by the donor of a remainder interest for a charitable purpose in certain cases. The charitable remainder must be in a trust, and the trust must be in the form of a charitable remainder annuity trust, or a charitable remainder unitrust, or a pooled-income fund.

A charitable remainder annuity trust is a trust from which a specified amount (not less than 5% of the initial net fair market value of the property placed in trust) is paid at least annually to one or more persons (who were living at the time the trust was created). At the death of the last income beneficiary, or at the end of a term of years (not greater than 20 years), the remainder interest must be held for the benefit of, or paid to, a qualified charitable organization.

Generally, a ***charitable remainder unitrust*** is a trust from which a fixed percentage (but not less than 5%) of the net fair market value of its assets, valued annually, is paid at least annually to one or more persons (who are living at the time of the creation of the trust). At the death of the beneficiaries or at the end of a term of years (but not greater than 20 years), the remainder interest is held for the benefit of, or paid to, a qualified charitable organization.

A pooled-income fund is a trust maintained by a charity to which an individual transfers property and retains a proportionate income interest for life or creates an income interest in such property for the life of one or more beneficiaries (living at the time of the transfer).

Any other form of charitable remainder interest will not qualify for the charitable deduction.

6) ***Income interests, guaranteed annuity interests, and unitrust interests.*** If the donor transfers an ***income interest,*** whether or not in trust, to a charity and the remainder to a noncharitable entity, the charitable deduction is disallowed, unless the income interest is in the form of a guaranteed annuity interest or unitrust interest.

The term ***guaranteed annuity interest*** means the right, pursuant to the instrument of transfer, to receive a determinable amount paid at least annually, for a specified term, or for the life or lives of an individual or individuals, each of whom is living at the date of the gift.

For example, the annuity may be paid for the life of an individual plus a term of years. An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the date of the gift.

A guaranteed annuity interest, not in trust, must be paid by an insurance company or by an organization regularly engaged in issuing annuity contracts.

The term ***unitrust interest*** means the right, given in the instrument of transfer, to receive payment, not less often than annually, of a fixed percentage of the net fair market value, determined annually, of the property which funds the unitrust.

A unitrust interest, not in trust, must be paid by an insurance company or by an organization regularly engaged in issuing interests otherwise meeting the requirements of a unitrust interest.

Partial interests, valuation. The amount of the deduction in the case of a partial interest (including a remainder interest) is the fair market value of the interest on the appropriate valuation date. The fair market value of an annuity, life estate, term for years, remainder, reversion, or unitrust interest is its present value.

If the valuation of the interest involved is dependent upon the continuation or termination of more than one life, or upon a term certain concurrent with one or more lives, a special factor must be used. Many of these factors may be found in, or are readily computed with the use of Publications 723, 723A, and 723B, which may be purchased from the Superintendent of Documents, U.S. Government Printing Office, Washington, D.C. 20402. If, however, a special factor is required in the case of an actual transaction, the Commissioner of Internal Revenue may furnish the factor upon request. See Part IV for the procedure for requesting actuarial factors.

B) Gifts to Spouse (Marital Deduction)

Donors who are citizens or residents are allowed a limited deduction for lifetime transfers made to their spouses.

Allowance of the gift tax marital deduction is based on the marital status of the donor and the donee at the time of the gift.

In the case of a donor who remarries, the amount of the allowable deduction is based on the total amount of gifts made to the donor's spouses.

A marital deduction is allowed only if the donor spouse is a citizen or resident of the United States.

Terminable interests. Certain property interests, called terminable interests, that are given to the spouse may not qualify for a marital deduction. A terminable interest is one that will terminate or fail after the passage of time or when some contingency occurs or some event fails to occur.

Examples of terminable interests are life estates, annuities, estates for a term of years, and patents. A terminable interest will ***not*** qualify for the marital deduction if a reversionary (or remainder) interest in the property is given for less than adequate consideration to any person other than the donee spouse (or retained by the donor) and such other person (or the donor) may possess or enjoy any part of the property after the termination of the donee spouse's interest.

Example. If Charles Herb gave his wife a patent that has a useful life of 10 years, he has given her a terminable interest. But, since no one will enjoy the use of the patent after her interest terminates, Charles is entitled to a marital deduction. However, if Charles gives his wife only the first 5 years of the patent and gives his son the last 5 years, he will not be entitled to a marital deduction.

Exception. There is, however, an exception to the terminable interest rule. A property interest, whether or not in trust, qualifies for the marital deduction, if the following five conditions are met:

1) A donee spouse is entitled for life to all the income from the entire interest;

2) A donee spouse receives such income annually or at more frequent intervals;

3) A donee spouse has the power, exercisable in favor of the donee spouse or the donee spouse's estate, to appoint the entire interest;

4) A donee spouse may exercise such power alone and (whether exercisable by will or during life) must be exercisable in all events; and

5) A donee spouse must have the only power to appoint any part of the interest in the property.

If either the right to income or the power of appointment given to the donee spouse pertains only to a specific portion of a property interest, the marital deduction is allowed only to the extent that the rights of the donee spouse meet all the five conditions for entire interests.

Partial interests. A partial interest in property is not treated as a specific portion of an entire interest unless the right of the donee spouse to income or the power constitute a fractional or percentile share of the entire property interest, so that such interest or share of the donee spouse reflects its proportionate share of the increase or decrease in the whole of the property interest to which the income right and the power relate. Thus, if the right of the spouse to receive income and the power extend to one-half or a specified percentage of the property, the interest is a specific portion. If the annual income of the spouse is limited to a specific sum, or if the spouse has a power to appoint only a specific sum out of a larger fund, the interest is not a deductible interest.

Civil service annuity. The election of a survivor annuity under the Civil Service Retirement System by a retiring federal employee is a transfer for which the marital deduction is not allowable.

Community property. No marital deduction is allowable for a gift by a donor to a spouse if the property transferred was, at the time of the gift, held by the spouses as community property under the law of any state or possession of the United States, or any foreign country.

Limitation. The deduction allowed in computing gifts is as follows:

1) The first $100,000 (reduced by any deductions allowed after 1976); and
2) 50% of such transfers in excess of $200,000.

The $3,000 annual exclusion is available for all gifts of present interests made to a spouse. The amount of the marital deduction under certain conditions is limited to the amount of the gift reduced by the annual exclusion.

The limitation on the estate tax marital deduction must be reduced by the amount of the gift tax marital deduction allowed for lifetime transfers in excess of 50% of the value of the transfers. Transfers not required to be included on a gift tax return are not considered.

This would apply when the lifetime gifts eligible for the marital deduction are less than $200,000.

C) Unified Credit

The one unified credit against estate and gift taxes replaces the $30,000 lifetime exemption for gift taxes that was allowable for gifts made before January 1, 1977.

For citizens or residents of the United States at the time of the gift, the credit is allowed against the gift tax as follows:

For gifts made:	The credit is:
After December 31, 1976, and before July 1, 1977	$ 6,000
After June 30, 1977, and before January 1, 1978	$30,000
After December 31, 1977, and before January 1, 1979	$34,000
After December 31, 1978, and before January 1, 1980	$38,000
After December 31, 1979, and before January 1, 1981	$42,500
In 1981 and thereafter	$47,000

Unlike the prior gift tax exemption, the unified credit against the gift tax is mandatory; it is not optional for the donor.

Adjustments to the credit. The amount of the allowable credit must be reduced by the amounts allowable as credits for all preceding calendar quarters.

The credit is reduced by 20% of the lifetime specific exemption allowed for gifts made after September 8, 1976, and before 1977. The credit is not reduced for any amount allowed as a specific exemption for gifts made before September 9, 1976.

Example 1. In October 1976, George Ash, an unmarried donor, made a gift to his niece, Sally, of property valued at $50,000. On George's federal gift tax return, George claimed all of the specific exemption in the amount of $30,000.

In February 1977, George made a gift to his nephew, Barry, of property valued at $100,000. In November 1978, George made a gift to his sister, Carol, of property valued at $20,000 and, in January 1979, George made a gift to Sally of property valued at $30,000.

On George's federal gift tax returns, the $3,000 annual exclusion was claimed for each of the gifts.

The October 1976 gift to Sally reduced the unified credit available to George by twenty percent of the specific exemption claimed by George, or $6,000.

The $100,000 gift to Barry in February 1977 is reduced by the $3,000 annual exclusion. The remaining $97,000 gift generates a tax of $24,800. Only $6,000 of the unified credit may be applied by a donor against gift taxes incurred before July 1, 1977. Because of his gift to Sally in October 1976, George's unified credit was reduced by $6,000. Therefore, no unified credit is available to George to reduce the gift tax of $24,800 in 1977. Consequently, the gift to Barry results in a tax of $24,800.

The November 1978 gift of $20,000 to Carol is reduced by the $3,000 annual exclusion. The remaining $17,000 gift generates a tax of $5,100. Since the unified credit available to George until January 1, 1979, is $28,000, the amount of $5,100 of unified credit is allowed against the tax. Therefore, no gift taxes are due for the gift to Carol.

The January 1979 gift of $30,000 to Sally is also reduced by the $3,000 annual exclusion. The remaining $27,000 gift generates a tentative tax of $8,260. Since the unified credit available to George until January 1, 1980, is $26,900 ($38,000 less $11,100), the amount of $8,260 of unified credit is allowed against the tax. Therefore, no gift taxes are due for this gift to Sally.

Example 2. The facts are the same as those in *Example 1*, except that George did not claim any of the specific exemption on George's federal gift tax return for the last quarter of 1976. In this situation, as in *Example 1*, the February 1977 gift of $100,000 to Barry is reduced by the $3,000 annual exclusion. The remaining $97,000 gift generates a tax of $27,120. Since only $6,000 of the unified credit may be applied against the gift tax incurred before July 1, 1977, the amount of $6,000 of unified credit is allowed against the gift tax. Consequently, a gift tax of $21,120 results from the gift to Barry.

The November 1978 gift of $20,000 to Carol and the January 1979 gift of $30,000 to Sally, as in *Example 1*, generate gift taxes against which the unified credit is fully applicable. Therefore, as in *Example 1*, there are no gift tax consequences with respect to those transfers.

Limitation. The amount of the credit that may be claimed for any calendar quarter may not exceed the amount of the tax imposed for that quarter.

15. Computation and Rates of the Federal Gift Tax

Except for the change in the marital deduction for gifts, the Tax Reform Act has not changed the method for determining total taxable gifts.

The total taxable gifts are the value of all gifts less the allowable deductions, and any allowable annual exclusions.

Gifts made before 1977 are taken into account to determine the rate at which the gifts, including those made after 1976, are taxed.

The gift tax is determined as follows:

1) Compute a tentative tax on the total taxable gifts made by the donor, including—
   a) The taxable gifts made before 1977,
   b) The taxable gifts made after 1976, and
   c) The taxable gifts made in the present quarter;
2) Compute a tentative tax on the sum of all taxable gifts made by the donor, excluding the taxable gifts made in the present quarter;
3) Subtract the tax computed in (2) from the tax computed in (1). This result is the gift tax before the available unified credit. The resulting gift tax is reduced by the amount of the unified credit available in the present quarter.

The unified tax rate, which is the same for estate taxes, is shown in the Tax Rate Schedule included in this section.

Gifts that must be included in the gift tax computation are only those gifts that were considered taxable gifts at the time they were made.

Most deductions that were available in computing taxable gifts made before 1977 are available if they were available at the time the gift was originally made.

The effect of these provisions is to allow a donor who made gifts between 1932 and 1938 to claim the $5,000 annual exclusion that was then available; and the $4,000 annual exclusion that was available for gifts made from 1939 through 1942.

However, the $50,000 lifetime exemption that was available until 1937 and the $40,000 lifetime exemption that was available after 1936 until 1943 must be disregarded. Only the $30,000 lifetime exemption amount may be used in computing all taxable gifts made prior to 1977.

The unified credit for gift taxes is allowed as a credit against the gift tax. See Section 14 for a further explanation of the credit.

Tax Rate Schedule

If the amount with respect to which the tentative tax to be computed is:	The tentative tax is:
Not over $10,000	18 percent of such amount.
Over $10,000 but not over $20,000	$1,800, plus 20 percent of the excess of such amount over $10,000.
Over $20,000 but not over $40,000	$3,800, plus 22 percent of the excess of such amount over $20,000.
Over $40,000 but not over $60,000	$8,200, plus 24 percent of the excess of such amount over $40,000.
Over $60,000 but not over $80,000	$13,000, plus 26 percent of the excess of such amount over $60,000.
Over $80,000 but not over $100,000	$18,200, plus 28 percent of the excess of such amount over $80,000.
Over $100,000 but not over $150,000	$23,800, plus 30 percent of the excess of such amount over $100,000.
Over $150,000 but not over $250,000	$38,800, plus 32 percent of the excess of such amount over $150,000.
Over $250,000 but not over $500,000	$70,800, plus 34 percent of the excess of such amount over $250,000.
Over $500,000 but not over $750,000	$155,800, plus 37 percent of the excess of such amount over $500,000.
Over $750,000 but not over $1,000,000	$248,300, plus 39 percent of the excess of such amount over $750,000.
Over $1,000,000 but not over $1,250,000	$345,800, plus 41 percent of the excess of such amount over $1,000,000.
Over $1,250,000 but not over $1,500,000	$448,300, plus 43 percent of the excess of such amount over $1,250,000.
Over $1,500,000 but not over $2,000,000	$555,800, plus 45 percent of the excess of such amount over $1,500,000.
Over $2,000,000 but not over $2,500,000	$780,800, plus 49 percent of the excess of such amount over $2,000,000.
Over $2,500,000 but not over $3,000,000	$1,025,800, plus 53 percent of the excess of such amount over $2,500,000.
Over $3,000,000 but not over $3,500,000	$1,290,800, plus 57 percent of the excess of such amount over $3,000,000.
Over $3,500,000 but not over $4,000,000	$1,575,800, plus 61 percent of the excess of such amount over $3,500,000.
Over $4,000,000 but not over $4,500,000	$1,880,800, plus 65 percent of the excess of such amount over $4,000,000.
Over $4,500,000 but not over $5,000,000	$2,205,800, plus 69 percent of the excess of such amount over $4,500,000.
Over $5,000,000	$2,550,800, plus 70 percent of the excess of such amount over $5,000,000.

Example. Bill Smith had made the following gifts:

In 1975, $53,000 to his son
In 1979, $153,000 to his daughter
In 1980, $23,000 to his son

All these gifts were gifts of present interests.

The computation of Bill Smith's taxable gifts for 1975 is as follows:

Total gifts		$53,000
Less: Annual exclusion	$ 3,000	
Specific exemption	30,000	
		33,000
Total taxable gifts		$20,000

The computation of the gift tax for 1979 is as follows:

Total gifts for 1979	$153,000
Less: Annual exclusion	3,000
Taxable gifts	$150,000
Plus: Prior taxable gifts	20,000
Total taxable gifts	$170,000
Tentative tax on total taxable gifts	$ 45,200
Less: Tentative tax on prior taxable gifts (using present tax rates)	3,800
Gross gift tax	$ 41,400
Less: Available unified credit	38,000
Net gift tax	$ 3,400

The computation of the gift tax for 1980 is as follows:

Total taxable gifts for 1980	$ 23,000
Less: Annual exclusion	3,000
Taxable gifts	$ 20,000
Plus: Prior taxable gifts	170,000
Total taxable gifts	$190,000
Tentative tax on total taxable gifts	$ 51,600
Less: Tentative tax on prior taxable gifts	45,200
Gross gift tax	$ 6,400
Less: Available unified credit ($42,500 – $38,000)	4,500
Net gift tax	$ 1,900

16. Gifts by Nonresidents, Not Citizens

Gifts by individuals who are neither citizens nor residents of the United States are subject to the federal gift tax if the property is situated in the United States. The tax applies only to real and tangible personal property whether the transfer is direct or indirect.

If a donor acquired U.S. citizenship only because of citizenship, birth, or residence in a U.S. possession, the donor is considered a nonresident not a citizen for gift tax purposes.

A) Situs of Property

Property transferred by a donor who is neither a citizen nor a resident of the United States is considered situated in the United States if it is:

1) Real property located in the United States;
2) Tangible personal property located in the United States; or
3) Intangible personal property consisting of a property right issued by or enforceable against a resident of the United States or a domestic corporation and intangible personal property of the following types:
   a) Shares of stock issued by a domestic corporation;
   b) A debt obligation of a citizen or resident of the United States, a domestic partnership, a domestic corporation (including moneys on deposit with a domestic corporation or its foreign branch), and any estate or trust (other than a foreign estate or trust); and
   c) A debt obligation of the United States, a state or any political subdivision thereof, or the District of Columbia.

The United States has concluded conventions for the avoidance of double taxation in the matter of gift taxes with two foreign countries, Australia and Japan. These conventions, in addition to making credit for gift taxes paid to those countries available to donors (who are citizens or residents of the United States), provide certain rules for determining the situs of property. These rules, which in some cases differ from those discussed, are used in determining the credit allowable to donors who are citizens or residents. They are also used for determining the property subject to tax on gifts by donors who are neither citizens nor residents, and who come within the scope of the conventions. For Australia, the rules of situs apply to the taxation of gifts by persons domiciled in Australia. For Japan, the rules of situs apply in cases when the donor's beneficiary is domiciled in Japan.

Additional information on the conventions may be obtained from the Internal Revenue Service.

B) Exclusions and Deductions

Exclusions. The $3,000 annual exclusion is available to nonresidents who are not U.S. citizens, as it is to U.S. citizens.

Unified credit. There is no unified credit allowable against the gift tax imposed on transfers by nonresidents, not citizens.

Charitable and similar gifts. The deduction for charitable and similar gifts by nonresidents who are not U.S. citizens, is governed by the same rules that apply to U.S. citizens and residents.

However, gifts to, or for the use of, a trust, community chest, fund, foundation, or fraternal order or society operating under the lodge system are deductible only if the gifts are to be used within the United States exclusively

for tax-exempt purposes. Also, if the gifts are made to or for the use of a corporation, the corporation must be one created or organized under the laws of the United States or of any state or territory thereof.

Gift to spouse (marital deduction). A marital deduction is allowed only if the donor spouse is a citizen or resident of the United States.

C) Gift by Husband or Wife to Third Party (Gift Splitting)

If either of the spouses is a nonresident not a citizen, they may not elect to *split* the gift made by one spouse to a third party.

17. Recipient's Basis In Gifts

To determine the recipient's basis in gift property, the donor's adjusted basis, its fair market value at the time of the gift, and the gift tax paid on the gift must be known.

Fair market value less than donor's adjusted basis. If the property was given to the recipient after 1920 and its fair market value at the time of the gift was less than the adjusted basis to the donor just before the gift, the recipient's basis for depreciation, depletion, or amortization and for gain on its sale or other disposition, is the same as the donor's adjusted basis. The recipient's basis for loss is the property's fair market value at the time of the gift.

However, if the donor's adjusted basis is used for determining a gain and a loss is computed, and then the lower fair market value basis is used for determining a loss and a gain is computed, there is neither a gain nor a loss.

Example. You received a gift of income-producing property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift was $9,000. If you later sell the property for $9,500, there will be neither gain nor loss. There is no gain because the basis for determining gain is $10,000; there is no loss because the basis for determining loss is $9,000.

Fair market value greater than donor's adjusted basis. If the property was given to the recipient after 1920 and its fair market value at the time of the gift was greater than the donor's adjusted basis just before the gift, the recipient's basis for depreciation, depletion, or amortization, and for gain or loss on its sale or other disposition, is the donor's adjusted basis at the time of the gift, increased by the gift tax paid on the gift. This basis, however, cannot exceed the fair market value of the property at the time of the gift.

Gift tax and gifts made before 1977. For gifts made before 1977, the recipient's basis in the property (donor's adjusted basis) will be increased by the total gift tax paid on the gift to you, but not above the fair market value of the gift. The effective date for an increase in basis because of the gift tax paid is September 2, 1958, or the date of the gift, whichever is later.

Example 1. You were given a residence in 1976. At the time of the gift, it had a fair market value of $21,000 and an adjusted basis to the donor of $20,000. The donor paid a gift tax of $500. Your basis for gain or loss, and for depreciation, if you rent out the residence, is $20,500, the donor's adjusted basis plus the gift tax paid.

Example 2. Assume the same facts as in the preceding example except that the gift tax paid was $1,500. Your basis is $21,000, the donor's adjusted basis plus the gift tax paid but limited to the fair market value of the residence at the time of the gift.

Gift tax and gifts made after 1976. For gifts made after 1976, the recipient's basis (donor's adjusted basis) will be increased by the portion of the gift tax paid that is attributable to the net appreciation in value of the gift. This portion is determined by multiplying the gift tax paid on the gift by a fraction. The numerator of the fraction is the net appreciation in value of the gift and the denominator is the amount of the gift. The net appreciation in value of the gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis.

Example. In 1979 you received a gift of property from your mother. At the time of the gift the property had a fair market value of $50,000 and an adjusted basis to her of $20,000. Assume that she paid a gift tax of $9,000 on the property. For purposes of determining depreciation, depletion, or amortization, and gain or loss, your basis is $25,400 computed in the following manner:

Fair market value	$50,000
Less: Adjusted basis	20,000
Net appreciation	$30,000
Gift tax paid	$ 9,000
Multiplied by ($30,000 ÷ $50,000)	
Gift tax attributable to net appreciation	$ 5,400
Adjusted basis of property to your mother	20,000
Basis to you	$25,400

Gift made before 1921. If the property was received before 1921, the recipient's basis for depreciation and for gain or loss on the sale or other disposition of the property is its fair market value at the time of the gift.

Part III
Tax on Certain Generation-Skipping Transfers

In general, distributions of assets from a generation-skipping trust are subject to a generation-skipping transfer tax. A generation-skipping trust is a trust that provides for benefits to pass to two or more generations that are younger than the generation of the grantor of the trust. The tax is not imposed on the outright transfer of property by a transferor to a person who is in a generation younger than the transferor's.

The generation-skipping provisions do not apply to transfers under a trust that was irrevocable on June 11, 1976 (to the extent the transfer is not made from additions to corpus after June 11, 1976).

These provisions generally will not apply to transfers under a revocable trust or will in existence on June 11, 1976, if the grantor dies before January 1, 1982, without having amended the trust instrument to create or increase the amount of any generation-skipping transfer. If the decedent, on June 11, 1976, was under a mental disability to change the disposition of property, this period shall not expire before the date that is two years after the date this person first regains competence to dispose of property.

All references in this publication to generation-skipping trusts include generation-skipping trust equivalents. Although it is not a trust, a generation-skipping trust equivalent is an arrangement that has substantially the same effect as a generation-skipping trust and includes life estates and remainders, estates for years, other split interests, insurance, and certain survivor annuities.

1. Generation-Skipping Transfers

Generation-skipping transfers (also referred to as transfers) include:

1) ***Taxable distributions;*** or

2) ***Taxable terminations.***

These terms do not include a transfer subject to estate or gift tax, a transfer that is eligible for the exclusion for transfers to grandchildren, or property subject to a prior transfer. These exceptions are discussed later in this section.

In the event the death of an individual or any other occurrence is determined to be a ***taxable termination*** and such occurrence requires the distribution of a portion or all of the same property in a taxable distribution, the transfer is deemed not to be a taxable distribution to the extent that it is a taxable termination.

A) Taxable Distributions

A taxable distribution is any distribution from a generation-skipping trust that is not out of the income of the trust to any younger-generation beneficiary who is assigned to a generation younger than the generation assignment of any other person who is a younger-generation beneficiary. An individual who has had only a future interest or future power (or both) in the trust is not considered to be a younger-generation beneficiary.

If there are distributions out of income and out of other amounts during the tax year of the trust, the distribution of the income is considered distributed to the oldest-generation beneficiary first.

Any portion of tax imposed on a generation-skipping transfer that is paid out of the income or corpus of a trust not distributed in the taxable distribution will be considered as an additional generation-skipping transfer.

B) Taxable Terminations

A taxable termination is a termination of the interest or power of any younger-generation beneficiary who is assigned to a generation older than the generation of any other person who is a younger-generation beneficiary of the trust. A taxable termination generally is a termination occurring by reason of death, lapse of time, or the exercise or nonexercise of the interest or power in a generation-skipping trust. The term does not include a termination of a future interest or future power (or both) in the trust.

Example. A trust established by the grantor provides for income to the grantor's child for life with the remainder to the grantor's great grandchild. When the grantor's child dies, and the remainder interest is transferred to the great grandchild, a taxable termination has occurred. In this situation the death of the child terminated the life interest of the younger-generation beneficiary (the child) who was a member of a generation older than that of any other younger-generation beneficiary (the great grandchild) under the trust.

An assignment of a beneficiary's interest in a generation-skipping trust will not be treated as a taxable termination. However, the death of the person making the assignment would be a taxable termination and the generation-skipping transfer tax will be imposed on the value of the trust on the date of this person's death.

Deemed transferees of certain terminations. If at the time of any termination it is not clear who will be the transferee of any portion of property transferred, then (except as provided in regulations to be prescribed by the Secretary) the portion will be deemed transferred on a pro rata basis to each beneficiary of the trust in accordance with the amount each of them would receive under the maximum exercise of discretion on their behalf. It is presumed that the discretion will be exercised per stirpes, unless otherwise stated.

Per stirpes means that a class or group of distributees take the share that their deceased ancestor would have been entitled to, taking it by their right of representing the ancestor and not as so many individuals.

Multiple present interests or powers in same generation. If two or more younger-generation beneficiaries with present interests or present powers are assigned to the same generation, the transfer constituting a taxable termination for each such beneficiary is deemed to occur when the termination of the last such present interest or present power occurs.

Example. A grantor creates a trust providing that the trustee, in his discretion, is to distribute the income for the benefit of the grantor's three children, A, B, and C, during their lives, and is to distribute the corpus of the trust to his great grandchildren upon the cessation of the life income interests. No tax would be imposed upon the death of A and B; upon the death of C, however, there would be a taxable termination with respect to the trust and the tax base (i.e., the trust assets) would be valued at that time.

More than one present interest or present power. If one younger-generation beneficiary of a trust has both a present interest and a present power, or more than one present interest and present power in the trust, the termination of each power or interest is treated as occurring when the termination of the last remaining interest or power occurs.

Example. If an individual is entitled to receive all the trust income until the individual dies or reaches age 35 and also has a power commencing at age 35 to withdraw 5% of the trust corpus for life, the generation-skipping tax would be imposed at the individual's death and not when the individual attains age 35.

Unusual order of terminations. If a present interest or present power of a younger-generation beneficiary terminates and immediately after such termination a beneficiary assigned to a higher generation has a present interest or present power in the trust, the interest or power of the younger-generation beneficiary will not be deemed to have terminated until such interest or power of the "older" generation beneficiary terminates.

Example. A discretionary trust is created providing income for life to the grantor's spouse and two children, Al and Bob, with the remainder to be distributed to their grandchildren. In this situation, if Al and Bob both die before the grantor's spouse, no taxable termination occurs until the spouse's death. However, at the spouse's death, Al and Bob would be deemed transferors and the tax base would be determined at the time of the taxable termination, that is, the spouse's death.

Where an unusual order of termination occurs, the rules for generation-skipping transfers shall be applied first to the termination of the interest or power of the older beneficiary as if this termination occurred before the termination of the power or interest of the youn-

ger beneficiary. The value of any property taken into account for purposes of determining tax (if any) imposed on the termination of the younger beneficiary's interest or power will be reduced by the tax imposed on the termination of the older beneficiary's interest or power.

Special rule. The rules just discussed in *Multiple present interests or powers in same generation,* and *Unusual order of terminations,* will both apply when a person assigned to the same generation as, or a higher generation than, the person whose power or interest terminates has a present power or interest immediately after the termination and this power or interest arises as a result of the termination.

C) $250,000 Exclusion for Transfers to Grandchildren

The first $250,000 of taxable terminations or distributions to the grandchildren of the grantor for each deemed transferor (generally, the child of the grantor who is the parent of a grandchild receiving the transfer) are excluded from the generation-skipping transfer tax. This limitation is applied to transfers from one or more trusts in the order in which the transfers are made or deemed made.

D) Prior Transfer Exclusion

The terms ***taxable termination*** and ***taxable distribution*** do not include transfers to the extent that:

1) The deemed transferor in any prior transfer of the trust property being transferred was assigned to the same generation as, or a lower generation than, the generation assignment of the deemed transferor in the present transfer;
2) The transferee in any prior transfer was assigned to the same generation as, or a higher generation than, the generation assignment of the transferee in the present transfer; and
3) The transfers are not made for the purpose or effect of avoiding the generation-skipping tax.

E) Termination of Power

In the case of termination of any power, the property transferred is deemed to be the property subject to the power immediately before the termination.

2. Younger-Generation Beneficiary and Beneficiary

A ***younger-generation beneficiary*** is any beneficiary who is assigned to a generation younger than the grantor's generation. The time for determining if a person is a younger-generation beneficiary is immediately before the transfer. In the case of a series of related transfers, the time for this determination is immediately before the transfer or series of transfers.

A ***beneficiary*** is any person who has a present or future interest or power in a trust.

The term ***power*** means the ability to establish or alter the beneficial enjoyment of the corpus or income of the trust. It does not include the mere right of management of the trust.

A person who has a right to income or corpus, or who is a permissible recipient of income or corpus, has an ***interest*** in a trust.

Limited power to appoint among lineal descendants of the grantor. An individual is not deemed to have any power in a trust if that individual does not have any present or future power in the trust other than a power to dispose of trust corpus or income to a beneficiary or a class of beneficiaries who are lineal descendants of the grantor assigned to a generation younger than the generation assignment of that individual.

Powers of independent trustees. An individual is not deemed to have a power in a trust if that individual:

1) Is a trustee who has no interest in the trust (other than as a potential appointee under a power of appointment held by another);
2) Is not a ***related or subordinate trustee;*** and
3) Does not have any present or future power in the trust other than a power to dispose of trust corpus or income to a beneficiary or a class of beneficiaries designated in the trust instrument.

Related or subordinate trustee. A related or subordinate trustee is any trustee who is assigned to a younger generation than the grantor's and who is:

1) The spouse of the grantor or of any beneficiary;
2) The father, mother, lineal descendant, brother, or sister of the grantor or of any beneficiary;
3) An employee of the grantor or of any beneficiary;
4) An employee of a corporation in which the stockholdings of the grantor, the trust, and the beneficiaries of the trust are significant from the viewpoint of voting control;
5) An employee of a corporation in which the grantor or any beneficiary of the trust is an executive;
6) A partner of a partnership in which the interest of the grantor, the trust, and the beneficiaries of the trust are significant from the viewpoint of operating control or distributive share of partnership income; or
7) An employee of a partnership in which the grantor or any beneficiary of the trust is a partner.

Ascertainment of generations. Generally, a generation is determined along family lines.

A generation to which any person, other than the grantor, belongs is determined according to the following rules:

1) An individual who is a lineal descendant of a grandparent of the grantor is assigned to that numbered generation that results from comparing the number of generations between the grandparent and the individual with the number of generations between the grandparent and the grantor;
2) An individual who at any time has been married to a lineal descendant of a grandparent of the grantor is assigned to the same generation as the lineal descendant;
3) The present or former spouse of the grantor is assigned to the grantor's generation; and
4) Relationships by half-blood or adoption are considered whole-blood relationships.

Example. A husband, wife, and their brothers and sisters would be one generation; their children including adopted children would be the first younger generation; the grandchildren would be the second younger generation, and so forth.

An individual not assigned to a generation pursuant to the foregoing rules is assigned to a generation based on his or her date of birth. Individuals not more than 12½ years younger than the grantor are treated as members of the grantor's generation. Individuals more than 12½ years younger than the grantor but not more than 37½ years younger would be considered members of the grantor's children's generation (the first generation younger than the grantor). Subsequent generations are measured from the grantor's birth every 25 years.

Individuals eligible to be assigned to more than one generation will be assigned to the youngest of the generations available.

If any beneficiary of the trust is an estate or a trust, partnership, corporation or other entity, each individual having an indirect interest or power in the trust through such entity is treated as a beneficiary of the trust and is assigned to a generation under the rules just described.

3. Deemed Transferors

The determination of the deemed transferor is important because the deemed transferor's marginal tax bracket is used to determine the amount of tax that is imposed on the transfer.

A deemed transferor of a generation-skipping transfer generally is the parent (living or deceased) of the transferee who is more closely related to the grantor of the property. If neither parent is related to the grantor, the parent having the closer affinity to the grantor is the deemed transferor.

However, if this parent is not a younger-generation beneficiary at any time, and there is another ancestor (grandparent, etc.) of the

transferee who is related to the grantor by blood or adoption (and not by marriage) and the ancestor is a younger-generation beneficiary of the trust, the youngest such ancestor who is also a younger-generation beneficiary is considered the deemed transferor.

Example. If a trust is created for the benefit of the grantor's grandchild for life with the remainder to the grantor's great grandchild, the grandchild is the deemed transferor when the trust property passes to the great grandchild.

If a trust is created for the benefit of persons outside the grantor's family, the deemed transferor is the parent of the transferee having the closest affinity or relationship with the grantor. Generally, this person will be the person named in the will or trust instrument, or the lineal descendant of that person having the intervening interest or power in the trust.

In the case of a sprinkling trust, a taxable termination does not occur until the interest of the last member of a generation of beneficiaries has terminated. At that point, each member of that generation becomes the deemed transferor with respect to trust property transferred to that member's descendants.

4. Computation of Tax

The amount of tax imposed on a generation-skipping transfer is the excess of:

1) A tentative tax (computed in accordance with the estate tax rate schedule, as in effect on the date of the transfer) on the sum of:
   a) The fair market value of the transferred property determined as of the transfer date or the alternative valuation date if elected,
   b) The aggregate fair market value of all prior transfers of the deemed transferor,
   c) The amount of adjusted taxable gifts (modified for any split gifts made within 3 years of death of a spouse) made after 1976 by the deemed transferor before this generation-skipping transfer, and
   d) The taxable estate of the deemed transferor, if the deemed transferor has died at the same time as, or before, this generation-skipping transfer;

OVER:

2) A tentative tax on the sum of:
   a) The aggregate fair market value of all prior generation-skipping transfers of the deemed transferor,
   b) The amount of adjusted taxable gifts made after 1976 by the deemed transferor, before the transfer, and
   c) If the deemed transferor had died at the same time as, or before, this transfer, the taxable estate of the deemed transferor.

For the applicable estate tax rate schedule, see Section 10 of Part I.

A) Multiple Simultaneous Transfers

If two or more transfers that are taxable and have the same deemed transferor occur by reason of the same event, the generation-skipping transfer tax imposed on each transfer is the amount that bears the same ratio to:

1) The generation-skipping transfer tax that would have been imposed if the aggregate of the multiple simultaneous transfers were treated as a single transfer, ***as***
2) The fair market value of each of the properties transferred in the multiple transfer ***bears*** to the aggregate fair market value of all property transferred.

B) Transfers Within 3 Years of Deemed Transferor's Death

The principles relating to adjustments for gifts made within 3 years of a decedent's death (see Section 7(J), *Transactions Within 3 Years of Death,* of Part I) will apply to generation-skipping transfers made during the 3-year period ending on the deemed transferor's date of death. The amount of the generation-skipping tax imposed on any transfer during the 3-year period will be redetermined as if the transfer had occurred after the death of the deemed transferor and appropriate adjustments will be made for the amount of any prior transfer taken into account by this deemed transferor as generation-skipping transfers or taxable gifts.

This treatment is similar to the estate tax treatment of gifts made within 3 years of a decedent's death. Thus, in this case, the generation-skipping transfer is to be taxed, at the deemed transferor's transfer tax rate, taking into account cumulative lifetime and death-time transfers and not just the adjusted taxable gifts as of the date of the generation-skipping transfer.

5. Alternate Valuation Date

The alternate valuation date is available when a taxable termination occurs at the death of the deemed transferor or when the death of an older-generation beneficiary causes a taxable termination. The election to use the alternate valuation date is made by the trustee of the generation-skipping trust; it is not required that the executor of the deemed transferor's estate also elect the alternate valuation date.

If the trustee elects the alternate valuation method on any generation-skipping transfer, the following date (in lieu of the date of the decedent's death) is the date on which the assets are valued:

1) ***The date of the death of the deemed transferor or beneficiary*** if there are one or more generation-skipping transfers from the same trust that has the same deemed transferor and that are taxable terminations occurring at the same time as the death of this deemed transferor (or at the same time as the death of a trust beneficiary assigned to an older generation than such deemed transferor);

OR

2) ***The date of the generation-skipping transfer,*** if there are one or more generation-skipping transfers from the same trust with different deemed transferors that are considered taxable terminations occurring on the same day and that would, but for the special rule for such terminations, have occurred at the same time as the deaths of the individuals who are the deemed transferors with respect to the transfers.

6. Deductions and Credits

A) Expenses

When a taxable termination occurs at or after the death of the deemed transferor, the amount of the generation-skipping transfer is reduced by any expenses, indebtedness, and taxes, and by any losses to the extent that a deduction would have been allowable for these items if the amount of the trust had been includible in the deemed transferor's gross estate and the deemed transferor had died immediately before the generation-skipping transfer. Therefore, trustee's fees, costs of administration, and other losses and expenses may be deducted from the amount of any generation-skipping transfer to the extent that these items are paid for or sustained by the trust, are attributable to property which is included in the generation-skipping transfer, and have not previously been deducted for estate or income tax purposes.

In the case of a taxable distribution, the amount of the generation-skipping transfer is reduced by any expense incurred in connection with the determination, collection, or refund of the generation-skipping transfer tax imposed.

B) Charitable Deduction

The estate or gift tax charitable deduction is allowed to the extent that the property passes to a charity.

C) Unified Credit

If the transfer occurs at, or after, the death of the deemed transferor, the unused portion of the unified credit is allowed as a credit against the generation-skipping transfer tax. The credit allowed under this rule cannot, however, exceed the generation-skipping transfer tax.

D) Credit for State Death Taxes

A credit is allowed against the generation-skipping transfer tax in an amount equal to the estate, inheritance, legacy, or succession tax actually paid to any state or the District of Columbia in respect to any property included in the generation-skipping transfer if the gen-

eration-skipping transfer occurs at the same time as, or after, the death of the deemed transferor. This credit is allowed only to the extent of the lesser of:

1) The portion of the taxes levied on the transfer; or
2) The excess of:
   a) The credit allowed for state death taxes for estate tax purposes if the adjusted taxable estate of the decedent had been increased by this transfer and all prior generation-skipping transfers that had the same deemed transferor and were subject to this tax, ***over***
   b) The total amount of credit for state taxes plus the aggregate amounts allowable with respect to the prior generation-skipping transfers.

E) Credit for Tax on Prior Transfers

The credit for tax on prior transfers is allowed as an offset against the generation-skipping transfer tax.

The prior transfer tax credit is to be available where the estate tax had been imposed on the property in trust, and within a 10-year period thereafter, the generation-skipping tax is imposed upon the death of the deemed transferor. Likewise, if the deemed transferor is deceased at the time of a generation-skipping transfer, property which is subject to the tax on generation-skipping transfers is to be treated as passing from the deemed transferor to the transferee, and the generation-skipping tax is to be treated as an estate tax for purposes of the previously taxed property credit.

7. Nonresidents, Not Citizens

If at the time of a generation-skipping transfer, a living deemed transferor is a nonresident, not a citizen of the United States, only property taken into account for gift tax purposes is considered for generation-skipping transfer tax purposes. Only such property will be taken into account in determining the basis of the property transferred.

On the other hand, if the deemed transferor (nonresident, not a citizen) has died at the same time as, or before, the transfer, only the property taken into account for estate tax purposes is considered for generation-skipping transfer tax purposes. Only such property will be taken into account for purposes of determining the basis of the property transferred.

8. Administration

A) Procedure

If the deemed transferor is dead at the time of a generation-skipping transfer, all the provisions that apply to the estate tax provisions will apply to generation-skipping transfers. If the deemed transferor is alive at the time of the generation-skipping transfer, all of the provisions relating to the administration of the gift tax provisions apply to generation-skipping transfers. These estate and gift tax rules apply only to the extent that they are not inconsistent with express provisions of the generation-skipping tax sections.

B) Return Requirements

Caution: The information on return requirements is based on the latest proof copy of Form 706-B that was available at the time this publication was printed. Please contact the Internal Revenue Service for a copy of the final version of Form 706-B.

Generally, a person described below must file a generation-skipping transfer tax return for every generation-skipping transfer for each deemed transferor. A return is required even though no tax is due for any reason, including the exclusion for property transferred to the grantor's grandchildren or the allowability of credits.

Generally, the following must file the generation-skipping tax return:

1) The transferee in the case of a taxable distribution.
2) The trustee in the case of a taxable termination. However, in the case of a trust equivalent, the transferee must file the return.

If the transferee is legally incompetent or otherwise incapable of making the return, the guardian of that person's property must file it. If no guardian has been appointed, the person having control of the transferee's property must file the return.

The personal representative must file a return for a transferee who dies before filing a return which was required.

The tax on generation-skipping transfers is reported on Form 706-B, *Generation-Skipping Transfer Tax Return.*

When filed. The due date depends upon the type of event that gives rise to the liability for the tax. See the *Instructions for Form 706-B.*

Where filed. The return is filed with the Internal Revenue Service Center with which an estate or gift tax return of the deemed transferor would be filed. The return for a nonresident, not a U.S. citizen, must be filed with the Internal Revenue Service Center, Philadelphia, PA 19255.

Amended Return. If a deemed transferor dies within 3 years after a generation-skipping transfer has occurred, an amended return must be filed for the transfer by the date 6 months after the last day allowed for filing the deemed transferor's estate tax return (including extensions).

For additional information, refer to the *Instructions for Form 706-B.*

If the Service proposes a different value of property for purposes of the generation-skipping tax, the trustee is entitled to request from the Service a statement concerning its basis for valuation of property included in the generation-skipping transfer.

C) Extensions of Time for Payment of Estate Tax

Extensions of time for payment of estate tax where the estate consists largely of interests in closely held businesses will not apply to generation-skipping transfers. The Service may grant an extension of up to 6 months for filing any return required with respect to a generation-skipping transfer, where reasonable cause can be shown, or grant an extension for the payment of the tax.

9. Liability for the Generation-Skipping Tax and Lien

A) Taxable Distributions

Neither the deemed transferor (nor his estate) is liable for the tax. The recipient of a taxable distribution is personally liable for the tax. The recipient's liability is limited to the fair market value of the interest received at the time of the distribution.

B) Taxable Terminations

If there is a taxable termination of a trust, the trustee is personally liable for the generation-skipping tax.

To minimize an undue administrative burden on the trustee, regulations will be issued on how a trustee may request information from the Internal Revenue Service concerning the transfer tax rate bracket of the deemed transferor.

If a transfer is made to the grantor's grandchild, the trustee may, under these procedures, request information concerning the extent to which the $250,000 exclusion has been used.

The trustee will not be liable for any increase in tax when the trustee has relied on the rate or remaining exclusion information supplied by the Service.

C) Lien

The generation-skipping transfer tax constitutes a lien on the property transferred until the tax is paid in full or the statute of limitations expires. When property passes to more than one transferee in a simultaneous transfer, the property passing to each transferee is liable for the full amount of tax on the entire transfer.

10. Miscellaneous

A) Disclaimers

For purposes of the new disclaimer rules, the event that triggers the 9-month period al-

lowed for an effective disclaimer is the original date the interest is transferred to the disclaiming party. For further discussion, see Section 10(B), *Qualified Disclaimers*, in Part II.

B) Deemed Transferor's Marital Deduction

If the generation-skipping transfer occurs at the same time as, or within 9 months after the death of the deemed transferor, the value of the gross estate of the deemed transferor is considered to be increased by the value of the amount of the generation-skipping transfer for the purpose of computing the marital deduction in the deemed transferor's estate.

Any increase in the amount of the marital deduction by reason of a generation-skipping transfer occurring after the death of the decedent (deemed transferor) is not to be treated as a terminable interest solely by reason of the fact that the maximum amount of the deduction is not known as of the date of death.

C) Income in Respect of a Decedent

Where certain rights to income are subject to the tax on generation-skipping transfers, and to the income tax, the income tax treatment of ***Income in respect of a decedent*** will apply. Thus, the recipient of this income (whether the trustee or a beneficiary of the trust) is entitled to a deduction in computing the income tax on this income for the generation-skipping tax in the same way as the recipient of income in respect of a decedent is allowed a deduction for the estate tax. See Publication 559, *Tax Information for Survivors, Executors, and Administrators* for an explanation of computing the estate tax deduction.

D) Redemption of Stock to Pay Death Taxes

If corporate stock is subject to the generation-skipping transfer tax as a result of a transfer that occurs at, or after, the deemed transferor's death, and a redemption of stock so transferred occurs (to pay estate taxes), then:

1) The stock is deemed to be included in the gross estate of the deemed transferor;
2) The estate, inheritance, legacy, and succession taxes (including any interest collected as part of such taxes) that are imposed because of the generation-skipping transfer are treated as being imposed because of the deemed transferor's death and for purposes of redemptions to pay death taxes rules, the generation-skipping transfer tax is treated as an estate tax;
3) The distribution period begins on the date of the generation-skipping transfer; and
4) The relationship between the corporate stock and the decedent's estate is measured with reference solely to the amount of the generation-skipping transfer.

The trust and the actual estate of the deemed transferor are to be treated separately for purposes of the redemptions to pay death taxes qualification requirements.

Redemptions to pay death taxes are discussed in Section 13(C), *Stock Redemptions to Pay Estate Taxes*, of Part I.

E) Basis Adjustment

If ***before the death*** of a deemed transferor, property is transferred to any person pursuant to a generation-skipping transfer, the basis of the transferred property in the transferee's hands is increased (not above the fair market value of the property) by an amount equal to that portion of the generation-skipping tax that is attributable to the excess of the fair market value of the transferred property over its adjusted basis immediately before the transfer.

If ***at the same time as, or after, the death*** of a deemed transferor, property is transferred to any person pursuant to a generation-skipping transfer, the basis of the transferred property is adjusted in a manner similar to that required for property acquired from a decedent.

If the deemed transferor is a nonresident, not a citizen of the United States, see Chapter 7.

Part IV Requests for Factors, Computations, and Rulings

If a factor, computation, or ruling is necessary to complete a tax return, you may request assistance by writing to the Internal Revenue Service, Assistant Commissioner (Technical), Estate and Gift Tax Branch, T:I:EG, 1111 Constitution Avenue, Washington, D.C. 20224.

The National Office issues rulings on transactions affecting the estate tax of a decedent before the estate tax return is filed. It will not issue a ruling for such matters after the estate tax return has been filed, nor will it rule on matters relating to the application of the estate tax to property or the estate of a living person.

The National Office issues rulings on transactions affecting the generation-skipping transfer tax before the return is filed. Rulings will not be issued until after the generation-skipping trust (or trust equivalent) has been established. Rulings will not be issued on a generation-skipping transfer tax matter before the subject distribution or termination takes place.

1. Information for Requests

Each request must contain the following items:

1) The names, addresses, and taxpayer identifying numbers of all interested parties.
2) A carefully detailed description of the transaction.
3) The location of the district office that has or will have jurisdiction over the return.
4) True copies of all contracts, wills, deeds, agreements, instruments, and other documents involved in the transaction. (Original documents should not be submitted because they become part of the Service file and will not be returned.)
5) If you furnish material facts to the Service by telephone or orally at a conference, you must promptly confirm them by letter to the Service, along with a declaration in the form described later in this section. This confirmation must be furnished within 21 calendar days to be considered part of your request.
6) A statement whether, to the best of your knowledge, the identical issue falls within one of the following categories.
   a) Is under examination by a District Director in a return of the taxpayer (or of a related taxpayer within the meaning of section 267 of the Code);
   b) Has been examined and the statutory period of limitations on assessment or refund of tax has not expired, or a closing agreement has not been entered into by a District Director;
   c) Is under consideration by an Appeals office in connection with a return of the taxpayer for a prior period, or such issue has been considered by an Appeals office and the statutory period of limitations, described in (b), has not expired, or a closing agreement has not been entered into by an Appeals office; or
   d) Is pending in litigation.
7) A statement whether, to the best of your knowledge, the identical or similar issue has been ruled on by the Service and, if so, when and with what results.
8) If after the request is filed but before the ruling is issued you are aware that an examination of the issue has been started by the District Director, you must notify the National Office of such action.
9) If you file the return before receiving the ruling from the National Office, you must attach a copy of the request to the return.
10) A power of attorney (Form 2848), signed by the transferor, or, if an estate, by the executor or administrator, authorizing you to represent the estate in this matter; and, if applicable, an Authorization and Declaration (Form 2848-D).
11) If more than one issue is presented in the request or a closing agreement is requested, a duplicate copy of the ruling request and all exhibits.
12) If you are contending for a particular determination, you must furnish an explanation of the grounds for your contentions, together with a statement of relevant authorities in support of your views. Even though you are urging no particular determination with regard to a proposed or prospective transaction, you must state your views as to the tax results of the proposed action and furnish a statement of relevant authorities to support such views.
13) You must inform the Service of, and discuss the implication of, any legislation, or tax treaties, court decisions, regulations, revenue rulings or revenue procedures that you determine are contrary to the position that you advance. If you determine that there are no contrary authorities, you must make a statement to this effect in your ruling request.
14) If your request involves an actuarial factor you must furnish the names, ages, and sex of all involved parties along with a narrative statement of any contingencies that are not adequately described in the instrument(s) submitted.
15) If you are requesting the computation of the tax due involving an interrelated computation you must furnish sufficient supporting data to enable the staff to make the computation. For most estates, copies of the will and relevant trust instruments, a schedule of assets and deductions, and a tentative computation of state taxes should accompany the request.

A) Additional Information

In addition, the request must contain the following:

1) A copy of the request and of supporting documents on which are indicated, in brackets, those portions you suggest be deleted and the statutory basis for each proposed deletion. In lieu of those copies, a statement may be submitted indicating that no deletions need be made except names, addresses, and taxpayer identifying numbers.
2) A statement, made in a separate document, in support of the deletions suggested, indicating which specific exemption provided by section 6110(c) of the Code applies to each bracketed portion.
3) A declaration signed by the person or persons by whom or on whose behalf the request for ruling is made, in the following form: "Under penalties of perjury, I declare that I have examined this request, including accompanying documents, and, to the best of my knowledge and belief, the facts presented in support of the requested ruling are true, correct, and complete."

NOTE. For more information about the procedures to be followed to promote efficient handling of your request, you should refer to Revenue Procedure 80-20 or consult your nearest Internal Revenue Service office.

B) Exemptions from Disclosure

Section 6110(c) of the Internal Revenue Code of 1954 is as follows:

(c) Exemptions From Disclosure.—Before making any written determination or background file document open or available to public inspection under subsection (a), the Secretary shall delete—
   (1) the names, addresses, and other identifying details of the person to whom the written determination pertains and of any other person, other than a person with respect to whom a notation is made under subsection (d)(1), identified in the written determination or any background file document;
   (2) information specifically authorized under criteria established by an Executive order to be kept secret in the interest of national defense or foreign policy, and which is in fact properly classified pursuant to such Executive order;
   (3) information specifically exempted from disclosure by any statute (other than this title) which is applicable to the Internal Revenue Service;

(4) trade secrets and commercial or financial information obtained from a person and privileged or confidential;

(5) information the disclosure of which would constitute a clearly unwarranted invasion of personal privacy;

(6) information contained in or related to examination, operating, or condition reports prepared by, or on behalf of, or for use of an agency responsible for the regulation or supervision of financial institutions; and

(7) geological and geophysical information and data, including maps, concerning wells.

The Secretary shall determine the appropriate extent of such deletions and, except in the case of intentional or willful disregard of this subsection, shall not be required to make such deletions (nor be liable for failure to make deletions) unless the Secretary has agreed to such deletions or has been ordered by a court (in a proceeding under subsection (f)(3)) to make such deletions.

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